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Customer No.: **07278**
U.S. Patent and Trademark Office

Docket No: 20107/1200838-US1

IN THE UNITED STATES PATENT AND TRADEMARK OFFICE

In re Application of: Earl ROTMAN, et al.

Serial No.: 10/709,329

Confirmation No.: 3328

Filed: April 28, 2004

Art Unit: 3624

Examiner: Not Yet Assigned

For: **STRUCTURE AND METHOD FOR CREATING
TRADEABLE FINANCIAL UNITS**

Mail Stop Petitions
Commissioner for Patents
P.O. Box 1450
Alexandria, VA 22313-1450

PETITION TO MAKE SPECIAL UNDER 37 C.F.R. § 1.102

Sir:

This is a petition for accelerated examination pursuant to 37 C.F.R. § 1.102(d) to advance the above-identified patent application out of turn for examination. This petition is accompanied by an authorization to charge the undersigned's deposit account No. 04-0100 in the amount of \$130.00, in satisfaction of the fee due under 37 C.F.R. §1.17(h). The Commissioner is also authorized to charge any further fees required in connection with this Petition or to credit any overpayment to Deposit Account No. 04-0100.

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I. Claims Directed to a Single Invention

It is believed that the claims as filed are directed to a single invention. If the Examiner determines that all pending claims are not directed to a single invention, applicants will make an election without traverse as a prerequisite to the grant of special status.

Claims 1-31 are pending. Claims 1, 7, 17, 19, 23, 28 and 30 are independent claims. Claims 1, 7, 17 and 30 are apparatus claims. Claims 19, 23 and 28 are method claims related to the subject matter of claims 1, 7, 17 and 30.

Claims 1-18 and 30-31 relate to an article suitable for trade as a unit, where the unit represents both ownership of an equity share of a company and ownership of a debt of the company. Claims 1-6 and 17-18 recite features of a unit representing both equity and debt of a company in a prescribed way according to a predetermined ratio. Claims 7-16 and 30-31 recite features of a similar unit that has additional features making the unit suitable for a subsequent offering by the company. Claims 19-27 are method claims reciting steps which create the article suitable for trading as a unit, as recited in claims 1-18 and 30-31. Claims 28-29 are method claims reciting steps which decompose the article suitable for trading into its constituent components.

II. Pre-Examination Search

The present invention is directed to a unit suitable for trade which represents both equity and debt of a company. A company offers the unit to potential holders (*i.e.*, investors) who then have simultaneously a direct ownership interest in the equity of the company and a

direct ownership interest in the debt of the company. The holders can receive dividend revenue from their equity ownership and interest revenue from their debt ownership.

Applicants submit that any pertinent prior art will have the words 'equity' and 'debt' in close proximity in the text, either in the same sentence or paragraph. To reduce the amount of hits that would result from using such common terms as 'equity' and 'debt,' a search strategy was developed which also employed the following words: offering, financial, interest or dividend, stock and trade or trading or tradeable. These words are common terms in the art for the present invention, and helped focus the pre-examination search.

A pre-examination electronic search, using the aforementioned keywords was performed on the Micropatent PATSEARCH database, which contains patents and publications for the following patent authorities: the U.S. Patent and Trademark Office, the European Patent Office, the World Intellectual Property Office, the Japanese Patent Office, the German Patent Office, the United Kingdom Patent Office, and the French Patent Office. The search yielded 171 hits; the results were reduced to 136 hits by including International Classification G06F 17/60.

In addition, substantially the same keywords were used to search non-patent publications using DIALOG Information Service's B ECON and Business ECON oneseach group files. These group files include the pertinent core search areas suggested in 66 Fed. Reg. 30167 as the core search areas for examination of business method patent applications in Class 705, as well as the Banking/Finance/Investment databases mandated for subclasses 35-39.

In addition, a manual keyword search was performed directly on the U.S. Patent and Trademark Office electronic database (granted and pre-grant publications).

Moreover, the USPTO database (granted) was searched using U.S. Classifications 705/35, 705/36, 705/37 and 707/104.

The search results were reviewed for documents that disclose material within the same area of the art as the claimed subject matter. Those documents deemed most closely related to the claimed invention are submitted herewith and discussed in the following section.

III. Discussion of References

A. Paul D. Hayward, *Income Trusts: A "Tax-Efficient" Product or the Product of Tax Inefficiency?*, 50 Canadian Tax Journal 1529, 1543. (2002)

Hayward discloses an income trust structure, which is conventional and known in the Canadian capital market. The structure allows the owners of a taxable corporation to retain many of the non-tax advantages of the corporate form while avoiding certain negative tax consequences associated with that form. A complete understanding of Hayward can be had from a review of that document.

Under the income trust structure, a mutual fund trust is interposed between the investing public and the operating company and acts as a holding entity for subordinated debt and common shares issued by the company. The trust raises funding to purchase the company's debt and equity by selling trust certificates, which transfer an ownership interest in the trust to its holder. Hayward describes this interposition of a holding entity as providing a

B. U.S. Patent No. 6,092,056

U.S. Patent No. 6,092,056 ("the '056 Patent") concerns a financial management system for administering a financial debt instrument traded as a listed security to investors. A complete understanding of the '056 Patent can be had from a review of that document. Among others things, the '056 Patent provides an optimized selection of shares which is designed to track the performance of a related equity index over a limited period of time. In its preferred embodiment the invention packages the baskets of shares as debt instruments which are traded as Optimal Portfolio Listed Securities ("OPALS"). The debt instruments are issued in different series which track the performance of domestic or foreign capital markets over different predetermined periods of time. Each of the OPALS is secured by the shares, or an Equity Linked Obligation ("ELO"), of the underlying basket of stock which is purchased and held by the financial management system. Upon maturity, OPALS are redeemable to the investors, or may be rolled over into a new debt instrument, designed to track the same or a different capital market.

Claim 1 is directed to an article suitable for trade as a unit and recites "equity shares in a company" and "debt of the company" where "said equity shares and said debt [are] represented by the unit in a prescribed way according to a predetermined ratio; wherein the unit provides direct ownership of said equity shares and said debt." In contrast, the '056 Patent discloses a financial instrument which is itself a debt secured by shares of stock related to an equity index, where the equity index consists of multiple companies. Therefore, the '056

Accordingly, neither does this portion of the '671 Application teach or suggest the invention of the pending claims.

D. U.S. Patent Application Publication No. 2003/0135446

U.S. Patent Application Publication No. 2003/0135446 ("the '446 Application") concerns a contingent convertible debt instrument containing a provision permitting conversion only if any of certain economically substantial contingencies are satisfied. The '446 Application discloses that upon satisfaction of the contingencies the debt instrument converts into shares of stock of a company. A complete understanding of the '446 Application can be had from a review of that document.

Claim 1 recites the features of an article suitable for trade as a unit which represents both equity and debt of a company in a "prescribed way according to a predetermined ratio; wherein the unit provides direct ownership of said equity shares and said debt." In contrast, the '446 Application discloses a debt instrument which, upon satisfaction of certain conditions, can be converted into all value of equity in a company. At no time is there an instrument that represents both equity and debt, or is such an article created or decomposed. Therefore, Applicants submit that the '446 application does not disclose or suggest the invention of any of the claims.

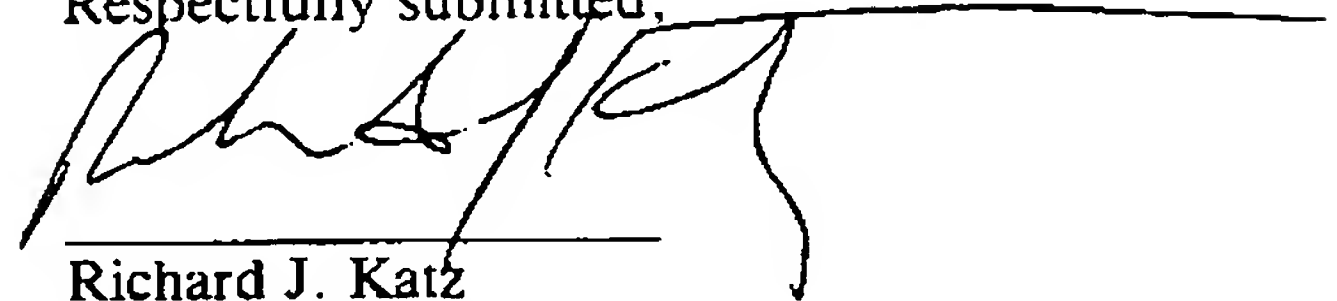
E. U.S. Patent Application Publication No. 2002/0052819

U.S. Patent Application Publication No. 2002/0052819 ("the '819 Application") concerns a method for issuing a financial instrument comprising the steps of acquiring or

In view of the foregoing, pursuant to 37 C.F.R. § 1.102(d) Applicants respectfully request that the Commissioner grant this Petition and accelerate examination of the application.

Favorable action is earnestly solicited.

Respectfully submitted,

A handwritten signature in black ink, appearing to read 'Richard J. Katz', is written over a horizontal line.

Richard J. Katz
Reg. No. 47,698
Attorney for Applicants

April 30, 2004

DARBY & DARBY, P.C.
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New York, NY 10150-5257
Phone (212) 527-7700



Customer No.: **07278**
U.S. Patent and Trademark Office

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For: **STRUCTURE AND METHOD FOR CREATING
TRADEABLE FINANCIAL UNITS**

Commissioner for Patents
P.O. Box 1450
Alexandria, VA 22313-1450

Request for a Pre-First Office Action Interview
Under the Pilot Program Announced March 31, 2004 and Effective May 3, 2004

Sir:

Applicants hereby respectfully submit a request to participate in the pilot program to conduct a pre-First Office Action interview with the Examiner assigned to the above-identified application.

Applicants have submitted, concurrently herewith, a Petition to Make Special in accordance with 37 C.F.R. § 1.102(d). The Petition includes identification of references

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believed to be the "closest" prior art and an explanation as to how the broadest claim distinguishes over the submitted prior art. Copies of the references accompany the Petition.

In accordance with the Notice announcing the pilot program, the following is a general statement of the state of the prior art at the time of the invention:

A private company seeking additional financing has limited choices. Existing working capital, cash flow and profits limit internally-financed growth and generally impact the availability of external financing. An Initial Public Offering (IPO) provides access to the capital marketplace; however, a private company's ability to raise funds in an IPO has certain limitations. The IPO marketplace generally disfavors mature, stable and modest-growth companies. These companies are often unable to successfully access the IPO marketplace.

Through the use of an Income Trust, such companies have been able to successfully access the IPO marketplace in Canada. A company issues subordinated debt and common shares to a trust that is organized exclusively for this purpose. The trust raises funding to purchase the company's debt and equity by selling trust certificates, which transfers an ownership interest in the trust to its holder. The trust certificate holders do not have any direct ownership interest in the equity or debt, nor do they have any direct voting rights in, or control of, the company. The U.S. legal and regulatory framework makes it practically impossible to replicate the Income Trust structure. U.S. companies, with the characteristics described above, have not had ready access to the IPO marketplace.

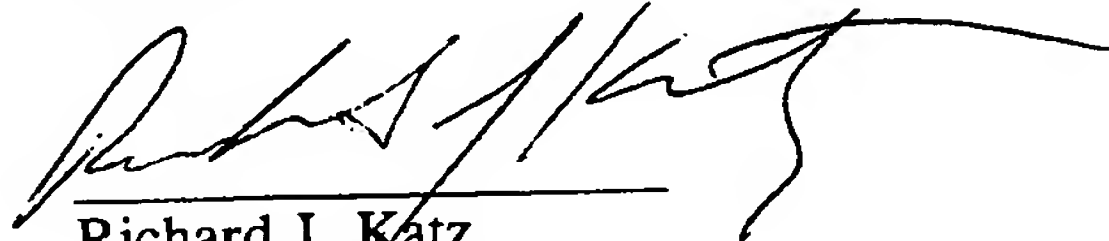
Applicants submit that the Petition to Make Special and this Request to Participate places the application in compliance with the requirements to participate in the pilot program, as outlined in the Notice dated March 31, 2004.

Favorable action is earnestly solicited.

April 30, 2004

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Post Office Box 5257
New York, NY 10150-5257
Phone (212) 527-7700

Respectfully submitted,



Richard J. Katz
Reg. No. 47,698
Attorney for Applicants

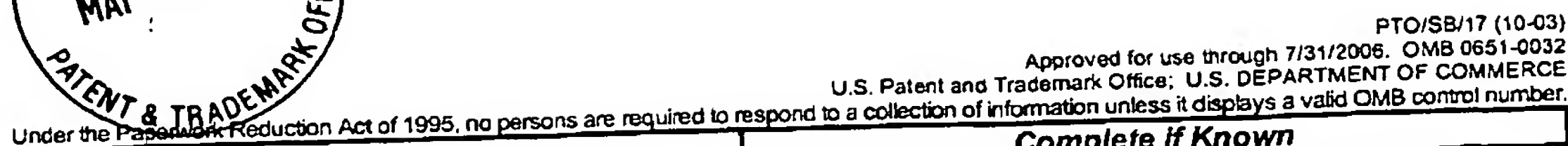


3624
✓

PTO/SB/21 (08-03)
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U.S. Patent and Trademark Office: U.S. DEPARTMENT OF COMMERCE
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TRANSMITTAL FORM <i>(to be used for all correspondence after initial filing)</i>	Application Number	10/709,329-Conf. #3328	
	Filing Date	April 28, 2004	
	First Named Inventor	Earl Rotman	
	Art Unit	3624	
	Examiner Name	Not Yet Assigned	
Total Number of Pages in This Submission	1	Attorney Docket Number	20107/1200838-US1

ENCLOSURES (Check all that apply)		
<input checked="" type="checkbox"/> Fee Transmittal Form <input type="checkbox"/> Fee Attached <input type="checkbox"/> Amendment/Reply <input type="checkbox"/> After Final <input type="checkbox"/> Affidavits/declaration(s) <input type="checkbox"/> Extension of Time Request <input type="checkbox"/> Express Abandonment Request <input type="checkbox"/> Information Disclosure Statement <input type="checkbox"/> Certified Copy of Priority Document(s) <input type="checkbox"/> Response to Missing Parts/Incomplete Application <input type="checkbox"/> Response to Missing Parts under 37 CFR 1.52 or 1.53	<input type="checkbox"/> Drawing(s) <input type="checkbox"/> Licensing-related Papers <input checked="" type="checkbox"/> Petition to Make Special <input type="checkbox"/> Petition to Convert to a Provisional Application <input type="checkbox"/> Power of Attorney, Revocation Change of Correspondence Address <input type="checkbox"/> Terminal Disclaimer <input type="checkbox"/> Request for Refund <input type="checkbox"/> CD, Number of CD(s) _____	<input type="checkbox"/> After Allowance Communication to Group <input type="checkbox"/> Appeal Communication to Board of Appeals and Interferences <input type="checkbox"/> Appeal Communication to Group (Appeal Notice, Brief, Reply Brief) <input type="checkbox"/> Proprietary Information <input type="checkbox"/> Status Letter <input checked="" type="checkbox"/> Other Enclosure(s) (please identify below): Request for a Pre-First Office Action Interview Under the Pilot Program Announced March 31, 2004 and Effective May 3, 2004
Remarks		
SIGNATURE OF APPLICANT, ATTORNEY, OR AGENT		
Firm or Individual name	DARBY & DARBY P.C. Richard J. Katz - 47,698	
Signature		
Date	April 30, 2004	



Effective 10/01/2003, Patent fees are subject to annual revision.

☐ Applicant claims small entity status. See 37 CFR 1.27

TOTAL AMOUNT OF PAYMENT	(\$) 130.00
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Complete if Known

Application Number	10/709,329-Conf. #3328
Filing Date	April 28, 2004
First Named Inventor	Earl Rotman
Examiner Name	Not Yet Assigned
Art Unit	3624
Attorney Docket No.	20107/1200838-US1

METHOD OF PAYMENT (check all that apply)

☐ Check ☐ Credit Card ☐ Money Order ☐ Other ☐ None

☒ Deposit Account:

**Deposit
Account
Number**

04-0100

Deposit
Account
Name

Darby & Darby P.C.

Name _____

The Director Is authorized to: (check all that apply)

☒ Charge fee(s) indicated below ☒ Credit any overpayments

☒ Charge any additional fee(s) or any underpayment of fee(s)

☐ Charge fee(s) indicated below, **except** for the filing fee to the above-identified deposit account.

FEE CALCULATION

1. BASIC FILING FEE

Large Entity		Small Entity		Fee Description	Fee Paid
Fee Code	Fee (\$)	Fee Code	Fee (\$)		
1001	770	2001	385	Utility filing fee	
1002	340	2002	170	Design filing fee	
1003	530	2003	265	Plant filing fee	
1004	770	2004	385	Reissue filing fee	
1005	160	2005	80	Provisional filing fee	

SUBTOTAL (1)	(\$)	0.00
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2. EXTRA CLAIM FEES FOR UTILITY AND REISSUE

2. EXTRA CLAIM FEES		Extra Claims	Fee from below	Fee Paid
Total Claims	<input type="text"/>	.. = <input type="text"/>	x <input type="text"/>	= <input type="text"/>
Independent Claims	<input type="text"/>	.. = <input type="text"/>	x <input type="text"/>	= <input type="text"/>
Multiple Dependent			<input type="text"/>	= <input type="text"/>

Large Entity		Small Entity		Fee Description
Fee Code	Fee (\$)	Fee Code	Fee (\$)	
1202	18	2202	9	Claims in excess of 20
1201	88	2201	43	Independent claims in excess of 3
1203	290	2203	145	Multiple dependant claim, if not paid
1204	86	2204	43	** Reissue independent claims over original patent
1205	18	2205	9	** Reissue claims in excess of 20 and over original patent

SUBTOTAL (2)	(\$)	0.00
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****or number previously paid, if greater. For Reissues, see above**

FEE CALCULATION (continued)

3. ADDITIONAL FEES

Large Entity		Small Entity		Fee Description	Fee Paid
Fee Code	Fee (\$)	Fee Code	Fee (\$)		
1051	130	2051	65	Surcharge - late filing fee or oath	
1052	50	2052	25	Surcharge - late provisional filing fee or cover sheet.	
1053	130	1053	130	Non-English specification	
1812	2,520	1812	2,520	For filing a request for <i>ex parte</i> reexamination	
1804	920*	1804	920*	Requesting publication of SIR prior to Examiner action	
1805	1,840*	1805	1,840*	Requesting publication of SIR after Examiner action	
1251	110	2251	55	Extension for reply within first month	
1252	420	2252	210	Extension for reply within second month	
1253	950	2253	475	Extension for reply within third month	
1254	1,480	2254	740	Extension for reply within fourth month	
1255	2,010	2255	1,005	Extension for reply within fifth month	
1401	330	2401	165	Notice of Appeal	
1402	330	2402	165	Filing a brief in support of an appeal	
1403	290	2403	145	Request for oral hearing	
1451	1,510	1451	1,510	Petition to institute a public use proceeding	
1452	110	2452	55	Petition to revive - unavoidable	
1453	1,330	2453	665	Petition to revive - unintentional	
1501	1,330	2501	665	Utility issue fee (or reissue)	
1502	480	2502	240	Design issue fee	
1503	640	2503	320	Plant issue fee	
1460	130	1460	130	Petitions to the Commissioner	130.00
1807	50	1807	50	Processing fee under 37 CFR 1.17(q)	
1806	180	1806	180	Submission of Information Disclosure Stmt	
8021	40	8021	40	Recording each patent assignment per property (times number of properties)	
1809	770	2809	385	Filing a submission after final rejection (37 CFR 1.129(a))	
1810	770	2810	385	For each additional invention to be examined (37CFR 1.129(b))	
1801	770	2801	385	Request for Continued Examination (RCE)	
1802	900	1802	900	Request for expedited examination of a design application	

Other fee (specify)

*Reduced by Basic Filing Fee Paid

SUBTOTAL (3)	(\$)	130.00
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(Complete (if applicable))

SUBMITTED BY

Name (Print/Type)	Richard J. Katz
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Registration No.
(Attorney/Agent)

47.698

Telephone (212) 527-7700

Signature

Date April 30, 2004

Income Trusts: A "Tax-Efficient" Product or the Product of Tax Inefficiency?

Paul D. Hayward*

PRÉCIS

Au cours des 18 derniers mois, les marchés financiers canadiens ont été témoin d'une explosion du nombre d'appels publics à l'épargne comportant une structure de fonds de titres à revenu fixe. Bien que la structure elle-même de fonds de titres à revenu fixe ne soit pas nouvelle, son application aux entreprises à l'extérieur des secteurs traditionnels de l'immobilier et du pétrole et du gaz est relativement récente. Selon l'auteur, la prolifération récente des fonds de titres à revenu fixe découlerait en grande partie du fait que ceux-ci sont utilisés comme une forme d'arbitrage fiscal. En effet, cette structure permet aux propriétaires d'une société imposable de conserver de nombreux avantages non fiscaux s'appliquant aux sociétés tout en évitant certaines conséquences fiscales négatives associées à ce mode d'organisation. Généralement, l'utilisation d'une société comprend un certain degré de double imposition. Bien que les particuliers actionnaires de la société qui résident au Canada puissent recouvrer une partie de l'impôt sur les bénéfices payé par la société au moyen du crédit d'impôt pour dividendes, la partie non recouvrée représente un coût réel à l'égard de l'impôt. De plus, si la société verse des dividendes à des entités exonérées d'impôt, comme un régime de retraite ou un régime de revenu différé, aucune somme ne peut être recouvrée sur l'impôt des sociétés payé par la société. La structure de fonds de titres à revenu fixe utilise un substitut de la société — une fiducie de fonds communs de placement ayant certains attributs de la société — afin d'éviter ces désavantages. Utiliser des titres de créance à rendement élevé comme substitut des capitaux propres d'une société permet de créer des intérêts déductibles qui visent à réduire grandement, sinon à éliminer l'impôt à payer par la société.

La prolifération de la structure de fonds de titres à revenu fixe soulève un certain nombre de questions troublantes du point de vue de la politique fiscale. Premièrement, cette structure peut donner lieu à une érosion importante de l'assiette de l'impôt sur les sociétés. Deuxièmement, la prolifération des fonds de titres à revenu fixe met en lumière une faille dans le régime fiscal, à savoir le défaut de la Loi d'appliquer un

* Legal counsel, Corporate Finance, Ontario Securities Commission. I wish to thank the following people for helpful comments in the preparation of this article: Margo Paul, Iva Vranic, Susan McCallum, Erez Blumberger, and Ilana Singer at the OSC; Neil Brooks and the members of the Tax Academics Seminar Group; and the three reviewers who provided comments on an earlier draft of this paper. Any errors or omissions are of course the responsibility of the author.

traitement uniforme et cohérent aux personnes morales (les sociétés et les fiducies de fonds communs de placement), aux intérêts économiques (les titres de créance et les capitaux propres), et aux flux de trésorerie (les intérêts et dividendes ou les distributions de fiducie et les dividendes), lesquels peuvent tous être, d'un point de vue économique, équivalents. Ce défaut a des implications importantes en ce qui a trait aux objectifs de la politique fiscale, soit l'efficacité, la simplicité et la neutralité.

L'auteur examine un certain nombre de réponses possibles de la politique fiscale aux questions soulevées par la structure. Les facteurs qui ont contribué à l'essor de la structure, comme le rôle accru des exonérations d'impôt dans le financement des entreprises canadiennes imposables et les économies fiscales substantielles pouvant être réalisées au moyen de cette forme, suggèrent que la structure de fonds de titres à revenu fixe est là pour rester. Étant donné la jurisprudence fiscale récente, il semble improbable qu'une remise en question de la structure de fonds de titres à revenu fixe obtiendrait beaucoup de succès. Il semble, par conséquent, qu'une certaine forme de réponse législative sera nécessaire.

ABSTRACT

Over the last two years, Canadian capital markets have witnessed an explosion in the number of public offerings involving an income trust structure. Although the income trust structure itself is not new, its application to businesses outside the traditional real estate and oil and gas sectors is relatively novel. The author argues that the recent proliferation of the income trust structure may be largely explained as a form of tax arbitrage. The structure allows the owners of a taxable corporation to retain many of the non-tax advantages of the corporate form while avoiding certain negative tax consequences associated with that form. The use of a corporation usually entails some degree of double taxation. Although a portion of the income tax paid by the corporation may be recovered by individual shareholders resident in Canada through the dividend tax credit, the unrecovered portion represents an absolute tax cost. Moreover, to the extent that dividends are paid to tax-exempt entities, such as pension plans and deferred income plans, there is no recovery of any of the corporate tax paid by the corporation. The income trust structure utilizes a corporate substitute—a mutual fund trust imbued with certain corporate attributes—to avoid these disadvantages. The use of high-yield debt as a substitute for equity at the corporate level allows for the creation of a deductible interest expense which is intended to substantially reduce if not eliminate tax at the corporate level.

The proliferation of the income trust structure raises a number of troubling questions from a tax policy perspective. First, the income trust structure may lead to a substantial erosion of the corporate tax base. Second, the proliferation of the income trust form highlights a flaw in the income tax system—namely, the failure of the Act to apply a coherent and consistent treatment to legal entities (corporations and mutual fund trusts), economic claims (debt and equity), and cash flows (interest and dividends/trust distributions and dividends) which, from an economic standpoint, may be equivalent. This failure has important implications for the tax policy objectives of efficiency, simplicity, and neutrality.

The author examines a number of possible policy responses to the issues raised by the structure. The factors that have contributed to the rise of the structure, such as the increasing role of tax-exempts in financing taxable Canadian businesses and the substantial tax savings which may be achieved through the use of the form, suggest that the

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INCOME TRUSTS ■ 1531

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income trust structure is here to stay. In view of recent tax jurisprudence, it seems unlikely that a challenge to the Income trust structure would meet with much success. Consequently, it appears that some form of legislative response will be necessary.

KEYWORDS: TRUSTS ■ FUNDS ■ CORPORATE TAXES ■ DIVIDENDS ■ INTEGRATION ■ ARBITRAGE

AN OVERVIEW OF THE INCOME TRUST PHENOMENON

The number of public offerings that involve an income trust structure has increased dramatically over the last two years.¹ In view of the otherwise moribund state of Canadian capital markets, this growth in income trust offerings is nothing less than phenomenal. Investor demand for income trusts has recently been characterized as a "mania" and the market for income trusts as a "bubble."² A recent study indicates that in the six months to June 30, 2002, income trust offerings composed approximately 94 percent of all initial public offerings in Canada.³ Income trusts now represent approximately 13 percent of the total number of issuers on the Toronto Stock Exchange; that percentage is expected to rise.⁴ Indeed, one observer has suggested that the Toronto Stock Exchange might one day become the "Toronto Income Trust Exchange."⁵

Although the income trust and its cousin the royalty trust are not new structures, their recent appearance in public offerings in sectors other than oil and gas and real estate is somewhat novel. Recent non-traditional income trust offerings include the Connors Brothers Income Fund (a sardine cannery),⁶ the A & W Revenue Royalties Income Fund (a restaurant),⁷ the Keg Royalties Income Fund (a restaurant),⁸ the Sun Gro Horticulture Income Fund (a distributor of peat moss),⁹ the Davis + Henderson Income Fund (a cheque printer),¹⁰ the Versacold Income Trust (an operator of refrigerated warehousing, distribution, and related businesses),¹¹ the General Donlee Income Fund (a manufacturer of precision-machined products for the military, aerospace, and other commercial industries),¹² the Swiss Water Decaffeinated Coffee Income Fund (a coffee producer),¹³ and the Prime Restaurants Royalty Income Fund (a restaurant).¹⁴ Such non-traditional uses of the income trust structure are expected not only to continue but to increase rapidly.¹⁵

Although non-tax considerations play an important role in the growth and proliferation of the income trust structure, its popularity is largely attributable to the fact that a public company (or a company that is seeking to go public) can achieve significant tax savings by altering the legal form of the publicly held entity. By interposing a mutual fund trust between the public investors and the operating corporation, the corporation may substantially reduce or eliminate corporate tax at the operating entity level and pass on those savings in the form of higher distributions to investors.

In short, the income trust structure effectively allows the owners of a taxable operating business to retain many of the non-tax advantages of the corporate form (such as limited liability) while largely avoiding certain tax disadvantages associated with the corporate form.¹⁶ Foremost among these disadvantages is the double

taxation of income earned by the corporation: once at the corporate level and again at the individual shareholder level. The federal dividend tax credit allows individual shareholders of public corporations to recover a portion—but only a portion—of the tax paid by the corporation on the income that generated the dividend. The unrecovered portion represents an absolute tax cost associated with the use of a corporation.

That tax cost can be avoided by the use of a “flowthrough” vehicle (a mutual fund trust) imbued with certain corporate attributes as a holding entity to capitalize the operating entity with high-yield debt. The income trust structure represents a market response to the Income Tax Act’s¹⁷ disparate tax treatment of legal entities (corporations and mutual fund trusts), economic claims (debt and equity), and cash flows (interest and dividends or trust distributions and dividends), all of which may, in many cases, be economically equivalent or nearly equivalent. Essentially, the income trust structure allows for the creation of a tax-advantaged form of equity that permits a tax-efficient dividend (that is, a distribution of earnings that is in the nature of a dividend but that is deductible to the payer).

In this article, I will briefly describe the income trust structure and examine the tax and non-tax reasons for using that structure, both generally and in the specific context of the recent IPO made by the General Double Income Fund under a prospectus dated April 24, 2002. I will then consider a number of tax policy issues raised by the income trust structure:

- It has been estimated that the income trust sector will account for more than \$1 billion in forgone corporate tax revenues in 2002.¹⁸ If the sector continues to expand at its current rate, Finance officials may need to take legislative action to protect the corporate tax base from further erosion.
- The proliferation of the income trust structure highlights a serious flaw in the income tax system—namely, the Act’s failure to apply a coherent and consistent treatment to legal entities, economic claims, and cash flows that differ in form but that may be equivalent in substance. A tax regime that seeks to tax an entity but that tolerates the avoidance of tax through a simple (though often costly) alteration of the entity’s legal form raises significant efficiency concerns about our tax system.
- The tax policy goals of simplicity and neutrality may be undermined by the income trust form. Some investors, particularly retail investors, may not understand that the product they are purchasing is packaged to resemble a fixed-income product but in reality is closer to an equity claim.¹⁹ Similarly, some investors may not grasp that part of the apparent “yield” represents a return of capital as opposed to a return on capital. If investors are being misled about the fundamental nature of their investments, then it may be argued that the Act is complicit in the deception.

Finally, I will briefly examine some possible responses to the policy concerns raised by the income trust structure:

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INCOME TRUSTS ■ 1533

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- a “do-nothing” response—acceptance of the income trust form as a manageable and temporary phenomenon that will decline naturally in popularity as markets pick up, interest rates rise, and new products become available;
- a challenge by the Canada Customs and Revenue Agency (CCRA) (1) to the reasonableness of the interest incurred in respect of high-yield debt, or (2) to the deductibility of the interest based upon the characterization of the debt as debt (given its equity-like features);
- a CCRA challenge under the general anti-avoidance rule (GAAR) in section 245 of the Act;
- the introduction of specific measures aimed at the income trust structure, such as an expansion of the existing thin capitalization rules or the imposition of a special tax similar to part XII.2 tax (tax on designated income of certain trusts);
- the introduction of specific measures aimed at tax-exempt entities, such as pension plans and deferred income plans, with a view to restricting their ability to participate in the financing of taxable Canadian businesses; and
- the elimination of the inconsistencies that led to the development of the income trust structure, such as the disparate tax treatment between interest and dividends.

WHAT IS AN INCOME TRUST?

An income trust is a trust that has been created specifically to allow a taxable corporation (and/or its shareholders) that seeks to raise money from the public to achieve certain tax and non-tax benefits (as described below). In essence, an income trust is simply a financing vehicle for certain types of businesses. The income trust is an offshoot of the royalty trust structure, which first appeared in the 1980s.²⁰ Historically, the use of royalty trusts and income trusts was largely confined to the real estate and oil and gas sectors. Today, however, the income trust structure is increasingly viewed as a de facto substitute for the corporate form in many non-traditional areas.

The recent proliferation of the income trust form can be explained by current market conditions: issuers' continued need for equity financing, low demand for conventional equity products, and high demand for a “yield” product.

Low Demand for Conventional Equity Products

In the Internet- and telecom-driven bull market of the late 1990s, issuers that sought to make a public offering had relatively easy access to capital. Investors, mesmerized by the prospect of skyrocketing share prices, were willing to pile into IPOs in the hope of obtaining a quick return through capital gains—that is, an appreciating share price. Over the last two and a half years, however, North American equity markets have declined somewhere between a third and a half.²¹ In the current market, characterized by stagnant or falling share prices, issuers can expect little demand from investors looking for short-term capital appreciation.

Although demand for a conventional equity product may have dried up, issuers still need financing and vendors still have an interest in selling their businesses by way of public offerings. With conventional channels closed to them, they must explore new avenues for financing opportunities.²² One such avenue is the "repackaging" of an equity product to resemble a traditional "fixed-income" product such as a T-bill, a GIC, or a corporate bond so that it is attractive to fixed-income investors looking for a relatively secure income stream.

High Demand for a "Yield" Product

Owing to "[t]he exponential growth of the retirement savings market and the traditional predilection in this market for yield product,"²³ the demand for fixed-income products has grown substantially in recent years. However, in the current low interest-rate environment, the return available from traditional fixed-income products is relatively poor in comparison with historical returns. Fixed-income investors are currently said to be "starving for yield."

Traditionally, fixed-income investors have not looked to equities for a stream of secure fixed income for several reasons:

- Although equity securities such as common shares may be purchased for income purposes (that is, dividends) rather than capital appreciation purposes, the entitlement to a dividend payment is not fixed in the same way that an entitlement to a payment of interest is fixed. Dividends are payable at the discretion of the issuer's board. Interest, by contrast, is required to be paid at a stipulated rate pursuant to a covenant in the debt instrument. Practically speaking, the dividend entitlement may be relatively constant, as is the case with certain blue-chip issuers. However, the issuer is not bound by a covenant to pay a dividend of any given size, or even to pay a dividend at all.
- Traditional fixed-income products tend to be relatively secure investments (relative to equities): equity represents a marginal rather than a fixed claim on the issuer.
- The tax system tends to discourage a distribution of corporate earnings in the form of a dividend in two important ways. First, the tax treatment of dividends is significantly less favourable to the shareholder than the capital gains treatment potentially available to the shareholder if the earnings are retained by the corporation.²⁴ Second, the tax treatment of dividends is significantly less favourable than the tax treatment of corporate earnings²⁵ distributed as "interest," since the latter is deductible to the payer and the former is not.²⁶
- Because of the relatively unfavourable tax treatment of dividends (and perhaps because of the managerial preference²⁷ to retain earnings), dividend payouts have declined substantially over the last 50 years.²⁸

Repackaging an Equity Product as a Fixed-Income Product

A corporate issuer that wants to make a public offering of common shares could attempt to sell the offering as a fixed-income-like offering by publicly adopting

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INCOME TRUSTS • 1535

a dividend policy that committed the issuer to pay out, to the best of its ability, a prescribed rate of dividends. However, in the absence of a corporate history of consistent payment of dividends, investors might be skeptical about the value of the commitment. Management could alter its dividend policy at any time. More importantly, the issuer would be committing itself to a long-term strategy of employing a tax-ineffective way to distribute corporate earnings.

This is where the income trust structure comes in: it allows the owners of a business to make what is in substance an equity offering "packaged" to resemble in form a fixed-income offering. The income trust structure enables a corporate issuer to commit itself to regular cash distributions that are in the nature of a dividend but that allow the issuer to avoid the negative tax consequences associated with dividends.

Tax Savings Achieved by the Income Trust Structure

By using an income trust structure, a taxable operating corporation (Opco) can, in certain circumstances, achieve significant tax savings. For example:

- substantial deferral or elimination of tax at the Opco level, at least for a time, through the use of high-yield debt, such that income flows through Opco to the Opco shareholders essentially tax-free;
- elimination of tax at the income trust level owing to the availability of deductions for income distributions by the trust to the beneficiaries of the trust;
- a deferral of tax on the income distributed by the trust to the unitholders of the trust, to the extent that the unitholders are tax-exempt persons such as pension plans, RRSPs, RRIFs, and other deferred income plans; and
- where the holders are not tax-exempt persons, a deferral of tax on the income distributed by the trust to the unitholders of the trust to the extent that the "yield" is characterized at law as a return of capital rather than a return on capital.

The mechanics of these savings are considered below, in the section entitled "The General Donlee IPO."

Income Trust Distributions as a Reliable Signal of Company Performance

In the wake of recent accounting scandals in the United States, investor confidence in corporate management and the accuracy of financial statements is at an all-time low. Investors are now turning to the income trust product because it appears to be a reliable mechanism for monitoring company performance and a safe alternative to leaving cash in the hands of management. Financial statements can be restated, but cash, once distributed, remains distributed.

Agency cost theorists have long argued that the regular payment of dividends by a corporation imposes a useful discipline on management.²⁹ However, as noted earlier, average dividend yields have fallen substantially over the last 50 years. Because the income trust structure effectively removes a significant tax impediment

to payment of dividends by issuers, the structure may be a healthy development from a corporate governance perspective.³⁰

Higher Valuations Through a Change in Form

Some observers have suggested that one may achieve a higher valuation for business assets by packaging them in the income trust form:

The significant number and size of new income fund offerings (particularly outside the traditional energy, resource and real estate sectors) attests to the attractiveness of these vehicles both to the vendor of assets and to the investing public. The reasons for the popularity of income funds are not hard to explain. From the vendor's perspective, packaging assets into an income fund frequently provides the most favourable valuation for the assets. From the investor's perspective, income funds are commonly seen as a high-yield, tax effective and moderate-risk alternative to fixed-income securities such as government or corporate bonds. [Emphasis added.]³¹

The suggestion that one can increase the selling price of a product simply by altering the form rather than the substance of the product (that is, repackaging a direct equity interest as an income trust investment) appears to run counter to "efficient market" theory, which suggests that, so long as all relevant information is adequately disclosed, the market will properly price a security. A simple alteration of the form of the security should not affect the market price or create a demand for a product where none otherwise exists. To the extent that an alteration in form does either of these things, one would expect arbitrageurs to enter the market to exploit the pricing differential and thus, over time, eliminate the inconsistency.³²

However, it may be the case that additional value can be "squeezed" out of an income trust offering, as compared with a conventional equity offering, for several reasons:

- Significant tax savings are achievable through the use of the income trust structure; to the extent that those savings are passed on to investors in the form of bigger distributions, an alteration of the legal form of an equity claim from direct to indirect should lead to a higher valuation.
- By altering the form of the equity security, an issuer may be able to make the equity security more attractive to different classes of purchasers. As is discussed later in this article, certain purchasers, such as tax-exempts, generally will prefer an investment return in the form of interest rather than a dividend. Other purchasers may prefer a return in the form of capital appreciation because of the prospect of a tax deferral and the preferential treatment of capital gains. By tailoring the attributes of an equity security to the different needs of different classes of purchasers, the issuer may be able to realize a higher price through an increase in overall demand.³³
- The market, or at least certain segments of the market, may misperceive the economic fundamentals of the product. The possibility that some investors may misprice their investment is discussed later in this article.

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INCOME TRUSTS • 1537

Before I turn to the policy considerations raised by the income trust structure, it may be helpful to examine a recent example of an income trust offering that illustrates the operation and mechanics of the form.

THE GENERAL DONLEE IPO

The initial public offering by the General Donlee Income Fund, made under a prospectus dated April 24, 2002, is useful as an example for three important reasons:

1. It is relatively recent, and the offering documents are publicly available on SEDAR.³⁴
2. It represents a non-traditional use of the income trust form of financing, and consequently illustrates the current trend toward substituting the income trust form for the conventional corporate form of offering.
3. The structure of the offering is relatively simple, and is easy to compare and contrast with the corporate form of offering.

Background

In April 2002, the shareholders of General Donlee Limited (GDL) used an income trust structure to make a public offering by way of prospectus of their securities in GDL ("the Donlee securities"). A summary of the offering (simplified in certain respects) follows.

1. GDL is a Toronto-based manufacturer of precision-machined products for the military, commercial, and general aerospace industries and for the industrial products and power generation industries. Its customers include General Electric, Pratt and Whitney, CAE Electronics, Rolls-Royce, Bell Helicopter, the US Navy, Ontario Power Generation Inc., Atomic Energy of Canada Limited, Husky Injection Moldings Systems, Philadelphia Gear, McLean Engineering, and American Maplan.³⁵
2. Immediately before the public offering was made, GDL was owned 80 percent by a private investment firm, Granite Investment Corp. ("Granite") and 20 percent by a management group ("the management group," and, with Granite, "the GD security holders").³⁶
3. It appears that the GD security holders wanted to take GDL public in order to cash out their equity positions in GDL.³⁷ However, for reasons that will be examined below, the GD security holders elected to cause GDL to go public *indirectly*, through an overlying holding entity, the General Donlee Income Fund ("the fund"), rather than directly. The interposing of a holding entity between public investors and the operating company allowed the GD security holders to achieve certain tax advantages. However, absent tax considerations, the offering remained in substance an offering by GDL.
4. The GD security holders caused the fund, a limited purpose trust, to be established under the laws of Ontario on March 14, 2002.

5. On April 24, 2002, the fund filed a (final) prospectus to qualify, inter alia, the distribution of 7,780,000 units at \$10 per unit ("the units"), for aggregate proceeds of approximately \$77,800,000. The fund used these proceeds, inter alia, to acquire the Donlec securities previously held by the GD security holders.³⁸
6. After the completion of the offering, all or substantially all³⁹ of the Donlec securities previously held by the GD security holders were held indirectly by investors through the fund.
7. After the fund's acquisition of the Donlec securities, the fund caused GDL to issue, and the fund to subscribe for, certain high-yield debt (bearing interest at 15.82 percent per annum) of GDL ("the Donlec notes").
8. After an internal reorganization,⁴⁰ the fund owned 100 percent of the common shares of GDL and 100 percent of the Donlec notes.

Costs Attributable to an Indirect Offering

Given that public investors hold 100 percent of the units of the fund and the fund holds 100 percent of the common shares of GDL (together with certain high-yield debt), it seems that the investors—in economic terms (and absent tax considerations)—are essentially in the position they would have been in if they had invested in GDL directly. Absent tax considerations, the interposition of a trust between investors and the operating company does not alter the economic nature of the investors' ownership interest. They simply hold their interest indirectly rather than directly.

Additional expenses arise when an additional tier is imposed between the investors in the offering and the entity that makes the offering: for example, the fund must be established and administered; two sets of financial statements must be prepared and audited; two boards must meet and coordinate their activities; and the level of foreign ownership of the fund must be monitored so that its mutual fund status is not impaired. The prospectus states that these additional costs are expected to be about \$500,000 per year:

Outlook

Prior to the completion of the Offering, General Donlec operated as a stand-alone operation. The establishment of General Donlec as a subsidiary of the Fund will result in incremental expenses estimated to be \$0.5 million annually (excluding interest charges on the Donlec Notes) in respect of administration and insurance costs.⁴¹

In addition, certain non-financial costs arise when the offering is structured as an indirect offering—for example, the complexity and uncertainty associated with an income trust product as opposed to a conventional common share offering. (This topic is discussed further in the section entitled "Tax Policy Issues.") Given these additional costs and given that (absent tax considerations) the investors are in much the same position they would have been in if they held securities of General

Donlec directly, why would the GD security holders go to the trouble and expense of structuring the offering as an indirect offering?

As was suggested earlier, it appears that the General Donlee offering was structured as an income trust offering principally for two (not unrelated) reasons: (1) significant tax savings were achievable, and (2) market conditions were likely to support a public offering structured as an income trust. Both of these reasons are examined below.

Tax Advantages of the Income Trust

The General Donlee Business

The General Donlee offering represents a sale of a business by the owners of the business, the GD Security holders, to public investors by way of a prospectus offering. The GD security holders could have structured the sale as a conventional IPO by GDL. However, at the time of the offering the market was characterized by stagnant or falling share prices, and it was likely that the offering would have been difficult to sell on those terms.

Although prospective investors might see little potential for short-term capital appreciation in a GDL common share offering, GDL itself has many characteristics that would be of interest to those looking for income rather than capital appreciation: it is a mature business; it has an established client base; and its cash flow is stable and high relative to necessary ongoing capital expenditures. In the absence of tax considerations, the GD security holders could have elected to structure the sale as a prospectus offering of GDL common shares to be sold as an income-producing investment. This could be achieved by causing GDL to adopt, upon closing of the offering, "a policy to distribute all of its available cash, subject to applicable law and compliance with its contractual obligations, by way of monthly dividends on its Common Shares or other distributions on its securities, after . . . satisfaction of its debt service obligations, if any."⁴² (In fact, this is the distribution policy adopted by GDL in the General Donlee income trust offering.)

However, in view of the relatively unfavourable tax treatment of distributions of earnings in the form of dividends—the dividend tax credit does not allow a full recovery of the corporate tax paid by the payer—a common share offering does not represent the best form of financing from a tax perspective; the income trust structure enables distributions in the nature of dividends but without the tax disadvantages associated with dividends.

Dividends and the Concept of "Integration"

Under the Act, a distribution of cash in the form of a dividend is, compared with other methods of distributing cash, relatively tax-inefficient. Except in limited circumstances, the Act fails to ensure complete "integration" when dividends are paid.⁴³

Owing to the operation of the federal small business deduction, the rate of corporate tax for Canadian-controlled private corporations (CCPCs) generally approaches the integration level of 20 percent for the CCPC's first \$200,000 of income

from an active business carried on in Canada. However, the benefits of the small business deduction are phased out for larger CCPCs. Moreover, for corporations that are not CCPCs (such as public corporations)⁴⁴ the basic corporate tax rate is significantly higher than the full integration rate. As some observers have noted, "Where the combined federal and provincial corporate rate of tax is anything other than 20%, the system of integration breaks down."⁴⁵

Because the Act fails to provide for full integration, there is a clear incentive to reduce or eliminate income at the corporate level so as to prevent this "tax leakage." The Technical Committee on Business Taxation (the Mintz committee) made this point:

At its current level, the dividend tax credit can result in a substantial amount of corporate-level income tax for which shareholders receive no credit on distributions—an amount referred to as unintegrated tax. In addition, the dividend tax credit is not refunded to pension plans, charities and other exempt entities when they receive dividends from Canadian corporations. The combination of these two factors quite naturally creates incentives for affected shareholders to attempt to reduce or avoid corporate-level income taxes for which they will receive only partial credit or no credit at all. Moreover, there is an incentive to organize businesses in forms other than corporations, so as to allow owners to directly obtain the benefits of net tax deductions (such as capital cost allowance) for tax purposes.

The rapid growth in public issues of interests in income and royalty trusts is an illustration of the impact of newer financing techniques to achieve these types of objectives. [Notes omitted.]⁴⁶

If the GD security holders had made a public offering directly, GDI would have become a "public corporation," and thus would be subject to a corporate tax rate substantially higher than necessary to ensure integration. The full amount of corporate tax paid by GDI will not be recoverable by the (Canadian-resident) shareholders of GDI through the dividend tax credit mechanism. In addition, to the extent that GDI shareholders are tax-exempt persons (such as pension plans, RRSPs, RRIIs, and other deferred income plans), there is no recovery of tax paid at the corporate level.

The Act's failure to ensure complete integration appears to reflect a tax policy decision that corporations should pay some tax. This seems reasonable in view of the benefits of carrying on business through a corporation (separate legal identity, limited liability, continuity of life, free transferability of interests, etc.). However, from a tax-planning perspective, the Act's failure to ensure complete integration suggests that the use of the corporate form is inefficient, since there are alternative ways to capitalize a corporation that do not result in such tax leakage. The principal way to avoid this leakage is to finance the corporation through debt rather than equity: interest generally represents a deduction to the payer, whereas dividends do not.

Although an income receipt in the form of interest ordinarily is taxed at a higher rate than an income receipt in the form of a dividend (owing to the dividend tax credit), taxpayers may nevertheless prefer to receive interest income instead of dividends: they may have losses or other (similar) deductions to use up, or they

may be non-residents who enjoy the benefit of a low treaty withholding rate.⁴⁷ And tax-exempt entities will always prefer interest income to dividend income.

Tax-Exempt Entities

Section 149 of the Act provides that certain specified entities are exempt from tax under part I of the Act. These include, inter alia, the following:

- pension trusts (trusts governed by a registered pension plan): paragraph 149(1)(o);
- trusts under RRSPs (to the extent provided by section 146): paragraph 149(1)(r);
- trusts under deferred profit-sharing plans (to the extent provided by section 147): paragraph 149(1)(s);
- trusts governed by registered education savings plans (to the extent provided by section 146.1): paragraph 149(1)(u); and
- trusts governed by RRIPs (to the extent provided by section 146.3).

In this article, I will refer to these tax-exempt entities as "tax-exempts."⁴⁸ Tax-exempts play a significant role in the financing of taxable Canadian businesses;⁴⁹ in 1996, pension plans and RRSPs accounted for approximately 21 percent of net wealth in Canada.⁵⁰ The Mintz committee noted as follows:

Although tax-exempts are not taxed directly on their investment income, they indirectly do bear tax at the corporate level on income derived from taxable business corporations in which they invest. This is likely to be a factor in the manner in which tax-exempts invest in Canadian capital markets. *It might, for example, bias tax-exempts to prefer investments in debt instruments that pay interest rather than comparable risk-adjusted equity investments that pay dividends.* Returns in the form of interest payments—which are deductible for income tax purposes to a taxable corporate payor, but are generally subject to full income taxation for recipients (other than tax-exempts)—will be higher on a before-tax basis than comparable returns in the form of dividends or capital gains on equity, which result in non corporate-tax level deduction but which carry beneficial tax treatment for taxable recipients. [Emphasis added.]⁵¹

A payment in the form of a dividend is generally not deductible to the payer; it is considered a distribution of after-tax earnings. An individual shareholder resident in Canada may claim a credit to reflect a portion of the corporate tax paid by the corporation. However, the balance of the tax paid by the corporation that is not reflected in the dividend tax credit represents an absolute tax cost, or tax leakage, at the corporate level. Moreover, to the extent that the dividends are paid to tax-exempts, there is no recovery of any of the corporate tax paid, since the tax-exempt has no taxable income against which to claim a credit.

As a result, a taxable corporation can offer tax-exempt investors a higher (pre-tax) rate of return if the investment has the legal form of debt. And as tax-exempts increasingly participate in the financing activities of taxable Canadian businesses, such businesses may reasonably be expected to bias their financing activities toward debt offerings (or offerings that contain debtlike features).⁵²

"Repackaging" Equity as Debt

In the General Donlee offering, the GD security holders were not simply seeking to raise additional financing for their business; they wanted to sell their ownership interest. In substance, they wanted to make an equity offering—that is, an offering of a security that contained customary features of an equity security (the right to vote, a residual claim on the earnings and assets of the business after fixed claims are paid out, etc.). For the reasons already discussed, however, it was important that the security have the legal characteristics of debt so that interest payments thereon would be deductible. This can be simply achieved by the use of a two-tier (or multi-tier) structure. A two-tier structure is used in order to “convert” the equity interest (that is, equity in the holding entity) held by public investors into interest-bearing debt (that is, debt of the operating entity) held by the holding entity. These two elements are at the heart of the income trust structure.⁵¹ The Donlee offering follows this strategy.

The General Donlee Example

In April 2002, the fund raised approximately \$77,800,000 in a prospectus offering. The fund used these proceeds to acquire the Donlee securities previously held by the GD security holders.⁵⁴ At this point, the fund took a number of steps that appear primarily⁵⁵ designed to create a new deductible interest expense. The fund transferred the Donlee securities to a subsidiary of the fund, effectively in consideration for high-yield debt that bore interest at 15.82 percent per annum (the Donlee notes). The subsidiary then amalgamated with GDI, and the resulting corporation (also called “General Donlee Limited”) inherited the high-yield debt obligation. The note indenture stated that the Donlee notes were to have an aggregate principal amount of Cdn\$82,952,046,⁵⁶ which appears to be substantially the entire consideration that was ultimately to be paid by the fund for GDL.⁵⁷ Consequently, upon completion of these steps, the fund owned 100 percent of the common shares of General Donlee and 100 percent of the Donlee notes.

Although the Donlee notes legally constitute debt, it appears that they are intended to represent a tax-advantaged form of equity, since they are “unsecured debt obligations of General Donlee and [are] subordinate in right of payment to other indebtedness of General Donlee.”⁵⁸ In other words, it may be that the only claims over which the holder of the Donlee notes—that is, the fund—will enjoy a priority are the common shares, which are also held by the fund. (Admittedly, there is some additional security over a conventional equity claim in that the fund should rank equally with trade debt and other ordinary unsecured liabilities.) In view of the relative insecurity of the Donlee notes, the interest rate of 15.82 percent per annum appears to have been considered a commercially acceptable rate that would satisfy the reasonableness requirement in paragraph 20(1)(c) of the Act.⁵⁹ Given the high rate of interest on the Donlee notes, it is likely that the expense created thereby will be sufficient to soak up all or substantially all of the profit at the GDL level. This is the first element at the heart of the income trust structure. The second

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element is the use of a two-tier (or multi-tier) structure to convert the owners' equity interest into a debt claim.

Interposition of a Holding Entity Between the Investors and General Donlec

The interposition of a holding entity between the investors and the operating entity (GDL) is not strictly necessary if the objective is simply to generate a substantial interest expense to wipe out profit at the operating entity level. However, the interposition of a holding entity provides a convenient way to "bundle" debt and equity interests into a single equity (or equity-like) security: a unit. This is illustrated as follows.

GDL could have made a direct offering of common shares and a separate offering of subordinated debt in order to create the necessary interest expense. However, that strategy would have changed a fundamental aspect of the deal, since the identity of the shareholders and the creditors would differ, and the debt would represent real debt rather than just a means to eliminate operating-entity-level taxation. The shareholders would rank behind an additional class of independent creditors whose interests might, in certain circumstances, diverge from those of the shareholders. In addition, notwithstanding that the terms of the Donlec notes represent commercial terms of indebtedness, it may be questionable whether the shareholders of GDL would be willing to authorize GDL to incur debt on these terms (for example, to pay interest at 15.82 percent per annum to arm's-length creditors, as opposed to the shareholders themselves).⁶⁰ Moreover, since the primary purpose of the debt is to generate an interest expense, the board will periodically have to decide whether to fund repayments of principal, renegotiate the interest rate, etc., all with a view to minimizing tax. If the debt were issued to independent creditors, market considerations would intrude on these deliberations and the board could find itself in a serious position of conflict.

Alternatively, GDL could make a public offering of a hybrid form of security (a "unit" issued by GDL) that contained both debt and equity features. The holders of the debt would then remain tied to the holders of the equity. However, this option could imperil the deductibility of the interest, since the hybrid nature of the security might invite a recharacterization of the security. Moreover, whatever the features of this hybrid General Donlec security, it must remain a qualified investment for tax-exempts. As a practical matter, the interposition of a holding entity between the investors and the operating entity probably represents the simplest solution and the best means of ensuring that the interest deduction remains impervious to challenge.⁶¹

A Mutual Fund Trust as the Holding Entity

The holding or distributing entity is invariably a flowthrough vehicle such as a unit trust,⁶² which qualifies as a mutual fund trust.⁶³ As a trust, the holding entity is entitled to a deduction for amounts distributed by it to its beneficiaries.⁶⁴ Because it is a mutual fund trust, its units are qualified investments for deferred income plans.

THE UNIT TRUST REQUIREMENT

In order to qualify as a mutual fund trust under subsection 132(6), the trust must first qualify as a unit trust, as defined in subsection 108(2). Generally, a trust may qualify as a unit trust if it satisfies the conditions in paragraph 108(2)(a)⁶⁵ (an "open-ended" trust) or paragraph 108(2)(b)⁶⁶ (a "closed-ended" trust).

As noted by Brussa⁶⁷ and Cannon,⁶⁸ given that an income trust portfolio typically consists of securities of a single issuer, income trusts are precluded from reliance on the definition of "unit trust" in paragraph 108(2)(b) owing to the provision in subparagraph 108(2)(b)(v) that not more than 10 percent of the trust's property may consist of bonds, securities, or shares in the capital stock of any one (non-governmental) corporation or debtor. Therefore, a typical income trust will need to qualify as an open-ended unit trust with a right of redemption that satisfies the criteria in paragraph 108(2)(a). The right of redemption need not be (and typically is not) intended to be the primary means by which a unitholder obtains a return of capital. However, for the CCRA to accept that the redemption right satisfies the redeemable-on-demand requirement in paragraph 108(2)(a), there must be circumstances in which it would be reasonable for an investor to exercise the redemption right (as opposed to simply selling in the secondary market).⁶⁹

The redemption right in the Donlee offering appears to be typical of such offerings:

- Units are redeemable at any time on demand by the holders thereof;
- On redemption, the holder is entitled to receive a price per Unit (the "Redemption Price") equal to the lesser of: (i) 90% of the "market price" on the principal market on which the Units are quoted for trading during the 10-trading day period commencing immediately following the date on which the Units were surrendered for redemption (the "Redemption Date"); and (ii) 100% of the "closing market price" on the principal market on which the Units are quoted for trading on the Redemption Date;
- Unitholders are generally entitled to receive cash upon the redemption of their Units, subject to certain limitations, including the limitation that the total amount payable by the Fund in respect of all Units tendered for redemption in the same calendar month does not exceed \$50,000;
- If a Unitholder is not entitled to receive cash upon the redemption of Units as a result of the foregoing limitations, then the Units tendered for redemption shall, subject to any applicable regulatory approvals, be redeemed by way of a distribution *in specie* of the assets (including, if applicable, a pro rata number of securities of General Donlee) held by the Fund and in accordance with the Declaration of Trust.⁷⁰

Although a redemption right has been created in order to satisfy the requirements of paragraph 108(2)(a), so long as the Donlee Trust remains listed it seems likely that the redemption right will rarely (if ever) be exercised: the redemption price is set at a discount to the market price, and the redemption procedure is likely to be more cumbersome than a simple sale into the market. In the event that the units are delisted or that there is demand for redemption in excess of what the fund is able or willing to bear, the Fund has the option of redeeming the units by distributing as a dividend in specie its holdings in GDL.

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THE MUTUAL FUND TRUST REQUIREMENT

In addition to qualifying as a unit trust, it is necessary for the income trust to qualify as a mutual fund trust. The term is defined in subsection 132(6):

- (6) Subject to subsection [132](7), for the purposes of this section, a trust is a mutual fund trust at any time if at that time
- (a) it was a unit trust resident in Canada,
 - (b) its only undertaking was
 - (i) the investing of its funds in property (other than real property or an interest in real property),
 - (ii) the acquiring, holding, maintaining, improving, leasing or managing of any real property (or interest in real property) that is capital property of the trust, or
 - (iii) any combination of the activities described in subparagraphs (i) and (ii), and
 - (c) it complied with prescribed conditions relating to the number of its unit holders, dispersal of ownership of its units and public trading of its units.

The "prescribed conditions" are set out in regulation 4801 and primarily require that a class of units of the fund be qualified for distribution to the public. Certain additional requirements are set out in subsection 132(7), which restricts non-resident ownership of the fund and effectively requires the trustee continuously to monitor the level of non-resident ownership and, in certain circumstances, implement procedures for cancelling (or for a forced sale of) units when the permitted thresholds have been crossed.⁷¹

The Income Trust as a Corporate Substitute

Owing to the income trust structure, holders of GD trust units are essentially in the same position (absent tax considerations) that they would have been in if they held common shares in a corporate holding entity (or indeed in GDL directly). Aside from the very different tax consequences, there is little to distinguish the fund from a corporate holding entity. As the Donlee offering illustrates, even though it is necessary for tax reasons to use a trust as the holding or distributing entity, it is possible to imbue the trust with corporate attributes to provide the trust beneficiaries with an economic claim very similar to a direct equity interest in GDL:

- The units have attributes similar to those of ordinary common shares (each carries a right to vote, a right to receive distributions of income in the nature of a dividend, and a right to receive a pro rata share of the net assets of the issuer in the event of the issuer's termination or winding up).⁷²
- Annual meetings of unitholders must be held at which trustees are elected, auditors appointed, and other matters ordinarily associated with annual meetings of shareholders voted on.⁷³
- The trustees have rights and obligations that explicitly parallel the rights and obligations of directors under corporate statutes.⁷⁴

TAX POLICY ISSUES

Threat to the Corporate Tax Base

The proliferation of the income trust structure raises a number of tax policy issues. The most important of these, at least to the federal Department of Finance, is the fear that the income trust financing structure may lead to a substantial erosion of the corporate tax base. A recent estimate suggests that the income trust sector, with a current market capitalization of \$47 billion, will account for more than \$1 billion in forgone corporate tax revenues in 2002.⁷³ If the income trust sector continues to expand at the current rate, finance officials may have to take action to protect the corporate tax base.

The Income Trust Form as Arbitrage

A second and perhaps more troubling concern relates not to the income trust structure per se but rather to what the proliferation of the structure tells us about our income tax system—namely, the Act's failure to apply a coherent and consistent treatment to legal entities, economic claims, and cash flows that differ in form but that are identical in substance.

The use of the income trust form of financing represents a market recognition that it is possible to exploit this inconsistency of treatment and, often, to construct one equivalent financial position that yields a more desirable result than another; in other words, the use of the income trust form is a classic example of tax arbitrage.

The income trust exploits a number of disparities in the Act's treatment of economic equivalents (or near equivalents):

- *Dividends versus interest.* A corporation may be capitalized by either debt or equity; a corporation is generally permitted a deduction for distributions of income as interest, but not for distributions of income as dividends.
- *Dividends versus trust distributions.* A trust is used as the distributing entity because a trust can be given corporate attributes and can serve as a de facto economic substitute for a corporation; however, a trust is generally permitted a deduction for dividend-like distributions of income to unitholders, whereas a corporation is not entitled to deduct dividends.
- *Capital gains versus income.* Cash flows that are characterized as "capital" enjoy a substantial tax preference over cash flows that are characterized as "income." The preference is twofold: first, only 50 percent of a capital gain is taxed as income; second, capital gains are taxed on a realization basis, whereas income is taxed on an accrual basis.
- *Passive investment versus active carrying on of business.* If an income trust structure is to achieve its tax objectives, it must qualify as a unit trust and a mutual fund trust. A mutual fund trust's activities are generally restricted to passive investments in specified qualified investments. If the mutual fund carries on business directly, it risks losing its mutual fund status. However, a mutual fund may, subject to certain conditions, invest all of its funds in a single

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operating entity that carries on an active business. Altering the form of an investment rather than the substance of the investment—the interposition of a single intervening corporate layer—is sufficient to transform an active business activity to a passive investment.

- *Corporate form versus trust form.* A trust is not subject to capital taxes such as the large corporations tax.

Although one can admire the ingenuity involved in devising structures to exploit the Act's inconsistent treatment of economic equivalents, the arbitrage opportunities raise serious efficiency concerns. A tax regime that seeks to tax an entity but that tolerates an avoidance of tax achieved through a simple alteration of the legal form of the entity is surely objectionable and frustrates the state's objective of ensuring that a given set of tax consequences follows the use of the corporate form. The taxpayer is able to avoid the undesirable tax consequences associated with the corporate form but is forced to incur substantial costs in establishing an elaborate, and somewhat artificial, structure to achieve that end. Those costs ultimately represent a waste of resources and a "dead weight" loss to society.

Additional Complexity and Uncertainty

The income trust structure also raises a concern about the tax policy goal of simplicity. Once again, this is a concern not so much with the structure itself but rather with the system that encourages the structure to flourish. The additional complexity of the income trust form is of particular concern because some investors, particularly retail investors, may not fully appreciate the economic fundamentals of their investment.

Some anecdotal evidence suggests that the growth in income trust products derives disproportionately from the retail investor market, and that institutional investor interest is limited.⁷⁶ If it is true that demand resides principally with retail investors—the least sophisticated segment of the market—one must ask whether retail investors fully understand that they are purchasing a product which, although it is packaged to resemble a fixed-income product, may in substance represent an equity claim. For example, Brussa has noted that

[I]n the current, arguably disinflationary, environment characterized by a significant decline in short-term interest rates . . . the fact that this financing vehicle tends to produce high levels of periodic distributions not accompanied by a decline in unit value (by reference to trading price) *causes investors to view units of royalty trusts or income trusts much in the same way as a bond. Therefore, units tend to trade at a high multiple of distributable cash flow which is analogous to a yield computation. They are therefore attractive to fixed-income investors.* [Emphasis added.]⁷⁷

The extent to which fixed-income investors understand that they are substituting low-risk and low-return income products (such as T-bills, GICs, and corporate bonds) for higher-risk and higher-return income products (such as equities) is

questionable. Because fixed-income products have traditionally been highly secure, the act of clothing an equity product in the form of a fixed-income product may confer an unwarranted appearance of security on the product.

For example, one recent advertisement for an income trust fund reads as follows:

I have good news for investors looking for an income product that can outperform T-Bills, GICs, bonds and many dividend mutual funds!

When you look at the monthly income paid to investors from [the advertised fund] over the last three years compared to other investments, you might be really surprised. Its forward yield has been between 13% and 15% each of the past three years. *The trust has a one-year trailing yield of 11.9%...*

Compare our performance to what you would have earned on other income investments. The yield of the average Canadian bond fund has been under 5% over the past 12 months, and on the average dividend fund, it has been less than 2.5%.

Note that the ad simply refers to the income trust as an "income product," and suggests that its yield is to be measured against that of other income products. Although some cautionary language is used in the ad, the overall impression (in my view, at least) is that the income trust product on offer bears a risk profile similar to that of traditional fixed-income investments, but offers much higher returns. To the extent that an income trust unit simply represents a repackaged equity interest, it should be substantially riskier than a T-bill, GIC, or corporate bond. One hopes that all investors will see that additional yield comes at a price—additional risk.

A second element of possible misperception is inherent in an income trust product. Income trusts are widely promoted as being "tax-advantaged" investments:

In a low interest rate environment, fixed income yields are not the only thing shrinking. So are dividend payouts, both on common shares and preferred shares. This leaves income-oriented equity investors increasingly looking beyond traditional sources.

"If you need tax-efficient income, income trusts are the only game in town," says John Priestman, managing director of Guardian Capital Inc. and co-manager with Kevin Hall of GGOF Guardian Monthly High Income Fund, the largest in the Canadian income trusts category. . . .

What makes income trusts so tax-effective is that much of their returns are deemed a return of capital. . . . Return of capital is not a free lunch. Any such payments reduce the adjusted cost base of the fund units held, increasing the amount of capital gains investors will be taxed on when they eventually redeem their units at a profit.

The advantage is capital gains are taxed at the lowest rate for most investors, and the holder gets to decide when to realize the capital gain. "You get the lowest tax rate, and at a time of your own choosing," Mr. Priestman says.⁷⁸

Brussa has argued that in fact this does not represent a tax advantage per se, since it is based on a misperception:

[T]he fact that distributions from [income] trusts are either entirely or partially characterized as the return of capital for income tax purposes (usually as a result of deductions available at the distributing entity level), *while considered yield in the eyes of*

most investors, results in distributions being considered tax-advantaged when compared to traditional yield products (namely, bonds and certificates of deposit)...

[T]he tax advantages of receiving a return of capital which is misperceived by the investor as yield is not a tax advantage per se. [Emphasis added.]⁷⁹

The extent to which a given income trust "yield" contains an element of returned capital depends on the particular trust. In the case of certain business trusts, such as the General Donlee Income Fund, it appears that the return-of-capital element will be small.⁸⁰

Neutrality

Still another concern relates to the tax policy objective of neutrality. The fact that issuers make public offerings indirectly through one or more overlying entities reflects an alteration of a form of business organization from simple to complex in response to tax considerations. The income trust form is most suited to established, mature businesses with few ongoing capital requirements, since the income trust form commits the business to divest itself regularly of its cash earnings in payments to its shareholders. Although this may represent a principal selling feature of the structure, one wonders whether all of the issuers now racing to adopt the income trust form are appropriate candidates for the form. Since the income trust offering is currently viewed as the only game in town, it may be that some issuers choose to adopt the structure because it is the only means to sell an offering.⁸¹

Other Regulatory Issues

The incentives to alter the form of an offering may create difficulties under other regulatory regimes, such as corporate and securities legislation. For example, when the form of the offering entity is changed from a corporation to a mutual fund trust (with corporate attributes), there is a risk that investors may lose limited shareholder liability, which is the foundation of corporate law.⁸² In the case of the Donlee offering, this risk appears remote,⁸³ in part because the fund apparently enjoys limited liability as a shareholder of GDI. However, in other circumstances (for example, if the fund were to incur indebtedness or guarantee indebtedness and such indebtedness or guarantee did not expressly limit recourse to the fund's assets),⁸⁴ it is less clear whether the investors in the fund would still enjoy limited liability.

The use of a trust as a substitute for the corporate form also appears to allow the promoters of the offering to pick and choose the corporate attributes they wish to retain (including attributes that are intended to be mandatory attributes of the corporate form), such as a shareholder's right to bring a derivative or oppression action.⁸⁵ Similarly, when the identity of the issuer that makes the public offering (an overlying holding entity rather than the operating entity) is altered, certain basic securities law requirements applicable to public companies may be avoided, since the operating entity does not become a "reporting issuer," and the multi-tier structure allows shareholders to disaggregate their holdings (and thereby potentially avoid rules relating to insider reporting, control block distributions, and takeover bids).

POSSIBLE POLICY RESPONSES

I have argued that the rapid increase in the use of the income trust structure as a de facto corporate substitute raises a number of troubling tax policy issues. Some response to these issues is required, since the status quo serves no one's interest (other than the interest of the professional advisers who are paid to set up the structures). However, the policy concerns associated with the income trust structure do not easily lend themselves to a solution. It is far from clear that there is any consensus about what the objectives of any reform should be or how to achieve those objectives even if they could be agreed upon. The income trust structure has arisen because of—and reflects fundamental tensions within—the income tax system. For example, one may reasonably assert that it is a general policy of the Act that corporations should generally pay some amount of tax.⁴⁶ Except to the extent that the small business deduction is available, some portion of the corporate tax paid by a corporation will not be recovered by shareholders through the dividend tax credit mechanism. The use of an income trust structure appears to be a clear attempt to subvert this policy, since the structure allows the owners of a taxable business to achieve the non-tax benefits of the corporate form while avoiding the tax consequences associated with it.

However, one might fairly argue that the income trust structure is simply an inevitable consequence of the various incentives sown throughout the Act to encourage, for example, self-provision for retirement. The Act expressly contemplates a flowthrough entity, a mutual fund trust, making a public offering and investing the proceeds of the offering in a single corporate business. Given the restriction of the existing thin capitalization rules to non-residents, it is difficult to argue that one may read in a policy intention that tax-exempts should be restricted in the use of debt in their financing activities. And yet a foreseeable consequence of the use of debt by tax-exempts is that tax at a corporate intermediary level may be substantially reduced or eliminated.

Consequently, although one might say that the income trust structure has the effect of undermining the general policy of the Act toward corporations, one might equally say that the structure serves to fulfill the Act's general policy of encouraging capital formation and self-provision for retirement. The problem is not so much with the structure per se as with the competing policy objectives in the Act. For this reason, one's view of the appropriate response to this problem depends upon one's view of which objective should take priority:

Depending on one's point of view, imposing some tax on [tax-exempts] is either an idea whose time has come, or a fundamentally wrong idea as a matter of general policy. . . . A decision to tax [tax-exempts] in respect of financing activities . . . is likely to provoke heated reaction not necessarily limited to the tax structure and policy issues involved.⁴⁷

Consequently, a policy response that does not address the underlying conflicts that drive the structure is unlikely to resolve much.

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With these comments in mind, it may be useful to consider a number of possible responses to the challenges posed by the income trust structure:

1. Acceptance of the income trust form as a manageable (and perhaps temporary) nuisance (in other words, do nothing).
2. A challenge by the CCRA to the reasonableness or deductibility of interest claimed in respect of the high-yield debt.
3. A challenge based upon GAAR.
4. The introduction of specific measures aimed at the income trust structure, such as
 - a. entity classification;
 - b. the introduction of specific measures aimed at tax-exempts;
 - c. a full integration model for public company dividends;
 - d. treatment similar to the US model (limited liability corporations and S corporations); and
 - e. an expansion of the thin capitalization rules.

Each of these proposed responses is considered briefly below.

The "Do Nothing" Approach

Given the difficult choices involved in formulating a policy response and the significant opposition that will undoubtedly meet any policy that seeks to reduce or eliminate the tax advantages of the income trust structure, it appears likely that Finance officials will choose the "do nothing" approach, at least in the short term,⁸⁹ in the hope that the current popularity of the structure will prove a passing thing: when markets pick up, corporations will return to more direct sources of financing, such as a common share offering; when interest rates rise, traditional fixed-income products will become more attractive; or income trusts may be the flavour of the month, and sooner or later poor performance by a high-profile trust will remove some of the shine from the brand. Although there is probably some validity to each of these arguments, the current popularity of the income trust structure is not likely to decline. The factors that have contributed to the rise of the structure, such as the role of tax-exempts in financing taxable Canadian businesses and the substantial tax savings that can be achieved by substituting debt for equity, suggest that the income trust is here to stay. In fact, some observers have predicted that in another 10 years "almost all the income-producing assets of corporate Canada will be hived off into income trusts."⁹⁰

In sum, the do-nothing approach is both undesirable and impractical. The longer a response is deferred, and the more pervasive the structure becomes, the more entrenched resistance to change will become.

CCRA Challenges to Interest Deductibility

As noted earlier, an income trust typically "converts" equity into debt through the use of a two-tier (or multi-tier) structure. The top tier (the holding or distributing

entity) makes an offering of equity-like securities (such as voting trust units). This entity then uses the proceeds of this offering to capitalize the operating entity with a substantial amount of high-yield debt, thereby creating a deductible interest expense for the operating entity. Because the debt held by the income trust is frequently subordinate to other forms of debt issued by the operating entity, from an economic perspective it is difficult to distinguish the debt from equity. In other words, "as the relative amount of debt increases [relative to the amount of equity], the claim that purports to be debt can be expected to take on more and more of the characteristics of equity until at some point the purported debt amounts to equity."⁷⁰ Consequently, one possible challenge to the income trust structure may lie in an attack on the characterization of the debt as debt, with a view to denying a deduction for the interest claim.

A second avenue that might be worthy of exploration is a challenge to the rate of interest at which the high-yield debt is issued. The Donlee notes bear interest at a rate of 15.82 percent per annum. Given that the principal intent behind the issuance of the Donlee notes appears to be to generate an interest expense high enough to soak up all or substantially all of the profit at the GDL level, one might argue that the claimed rate of interest does not satisfy the reasonableness requirement in paragraph 20(1)(c).⁷¹

It seems unlikely, however, that either challenge would meet with much success. Over the last several years, the Supreme Court has consistently held that if a transaction is legally effective and is not otherwise a sham (such that the legal form of the transaction does not accurately reflect the parties' actual legal positions), then the court must respect the legal form of the transaction without regard to the underlying economic purpose, even where the primary economic purpose of the transaction is clearly to reduce the tax that would otherwise be payable.⁷² Consequently, so long as the debt meets the traditional legal requirements for commercial law purposes,⁷³ the courts appear willing to respect the characterization of the debt as debt.

With regard to the rate of interest claimed in respect of the debt, one might ask whether the management of General Donlee would have been willing to enter into a debtor-creditor relationship with arm's-length creditors on the same terms that were agreed with the income trust (that is, a relationship in which the borrower genuinely wished to borrow on the most favourable terms available, as opposed to an arrangement whereby both parties had an incentive to inflate the interest rate).

In this instance too it seems doubtful that the courts would uphold a challenge to the reasonableness of the interest claim. Perhaps ironically, it is the equity-like characteristics of the Donlee notes (that is, the relative insecurity vis-à-vis other forms of debt) that serve to justify the higher interest rate:

Whether the . . . condition of reasonableness will be satisfied will turn on the facts. Having regard to the credit risk of the particular issuer and the term of the indebtedness, is the interest rate reasonable? Since the shareholder of the issuer, the income trust, is also the holder of the debt, a highly leveraged financing with an extended

term is possible. Since the issuer is highly leveraged and the debt obligation is not payable for many years, a higher interest rate can be justified. Opinions from qualified investment dealers are usually obtained confirming that the rate of interest on the notes is a commercially reasonable rate.⁹⁴

A GAAR Challenge

The GAAR was introduced in 1988 to replace an earlier version of section 245, which attempted to police perceived abuses associated with the claiming of excessive deductions as a means of unduly or artificially reducing a taxpayer's income. The present version of section 245 is drafted much more broadly and attempts to minimize opportunities for tax avoidance by ignoring, for tax purposes, the consequences of avoidance transactions.

On its face, the income trust structure appears to fall within the GAAR definition in subsection 245(3) of an "avoidance transaction" in that (1) the use of the structure clearly results in a tax benefit—the reduction or elimination of corporate tax at the operating entity level—and (2) it is difficult to argue that the use of the structure can "reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit."

However, subsection 245(4) then appears to place this conclusion in doubt: it states that "subsection 245(2) does not apply to a transaction where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provisions of this Act or an abuse having regard to the provisions of this Act, other than this section, read as a whole" (emphasis added). It would be difficult to suggest that the income trust structure involves a misuse of any of the provisions of the Act. There is nothing particularly creative or innovative in how the income trust structure uses the Act; for example, although it may seem odd that a mutual fund trust can restrict the entirety of its investing to a single issuer, the definition expressly contemplates this scenario. Similarly, although the income trust structure may seem "abusive" in that it appears to subvert the general policy that corporations should pay some amount of tax, it can equally be said that the structure fulfills the general policy of the Act that encourages capital formation and retirement savings.

If there was a reasonable doubt about whether subsection 245(2) applied to the income trust structure, that doubt has surely been dispelled by the jurisprudence on the GAAR that has developed over the last 12 years. As is discussed elsewhere,⁹⁵ the Supreme Court of Canada has consistently reaffirmed the *Duke of Westminster* principle that "[e]very man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be."⁹⁶ In other words, so long as the parties negotiate a legally effective transaction and the transaction is not at law a "sham," then the legal form of the transaction will be respected, and the revenue authorities will not be permitted to recharacterize a transaction in accordance with its perceived economic substance rather than its apparent legal form.

Space does not permit a comprehensive discussion of issues relating to tax avoidance. However, this article would not be complete without at least a passing

reference to the recent decision of the Supreme Court of Canada in *Shell Canada Ltd. v. Canada*.⁹⁷ In that case, the court refused to allow the minister to recharacterize a transaction in terms of its economic substance, and reaffirmed in unambiguous terms a taxpayer's right to structure his or her affairs, by means of legally effective transactions, so as to reduce the amount of tax otherwise payable.

The facts in *Shell Canada* are complex and need not be set out in detail here. Essentially, Shell Canada needed to borrow \$100 million in US funds for five years for general corporate purposes. The prevailing interest rate for a direct borrowing by Shell Canada of such funds was approximately 9.1 percent. This interest cost represented a deductible expense to Shell Canada. Shell Canada wanted to reduce its financing costs, and Goldman Sachs proposed a strategy known in tax circles as a Kiwi loan (a loan of New Zealand dollars) and certain hedging transactions. The prevailing market rate for a loan of an equivalent amount of funds in New Zealand dollars was 15.4 percent. Accordingly, there was a higher interest rate cost (and thus a higher annual expense, deductible from income) associated with the New Zealand borrowing, which was then immediately converted into US funds. However, the higher interest rate payable on the borrowing of New Zealand funds was effectively equalized by a discounted forward rate for New Zealand currency at the maturity date of the borrowing. In other words, at the time of the initial borrowing, it could be determined that, at the maturity date, the principal amount of US\$100 million would return a greater number of New Zealand dollars than had been initially borrowed. Since risks associated with foreign exchange fluctuations had otherwise been hedged, Shell Canada was able to predict with reasonable certainty that it would achieve a gain on the capital account which would effectively equal the increased expense on the income account.

The addition of the Kiwi loans and the hedging structure was a pure arbitrage play. The trial judge found that Shell Canada had no use for the New Zealand funds other than as part of the overall structure, and that Shell Canada's overriding purpose in entering into the various transactions was to secure US\$100 million at the lowest possible after-tax cost. The aggregate effect of the various transactions was (1) to increase an interest expense on a borrowing from 9.1 percent to 15.4 percent, and (2) to generate a capital gain at the term of the loan corresponding to the increased interest cost. This structure was advantageous because (1) Shell Canada had certain capital losses that it could not offset against income but only against capital gains, and (2) capital gains were taxable at a discounted rate. The strategy clearly recognizes that the income tax system in Canada frequently taxes equivalent financial positions differently.

Madam Justice McLachlin wrote for the court:

[T]his Court has made it clear in more recent decisions that, absent a specific provision to the contrary, it is not the courts' role to prevent taxpayers from relying on the sophisticated structure of their transactions, arranged in such a way that the particular provisions of the Act are met, on the basis that it would be inequitable to those taxpayers who have not chosen to structure their transactions that way. . . . Unless the Act provides otherwise, a taxpayer is entitled to be taxed based on what it

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actually did, not based on what it could have done, and certainly not based on what a less sophisticated taxpayer might have done.

Inquiring into the "economic realities" of a particular situation, instead of simply applying clear and unambiguous provisions of the Act to the taxpayer's legal transactions, has an unfortunate practical effect. This approach wrongly invites a rule that where there are two ways to structure a transaction with the same economic effect, the court must have regard only to the one without tax advantages. With respect, this approach fails to give appropriate weight to the jurisprudence of this Court providing that, in the absence of a specific statutory bar to the contrary, taxpayers are entitled to structure their affairs in a manner that reduces the tax payable.⁹⁸

In the *Shell* case, these words were directed at a complicated transaction involving a foreign currency swap, which was intended in large part to "inflate" a deductible interest expense. Although the facts of the transaction may be different, there is little reason to believe that Madam Justice McLachlin's comments would not apply to a GAAR challenge of an income trust structure.⁹⁹

Specific Measures Aimed at the Income Trust Structure

If Finance determines (as I think it must) that a response to the challenges posed by the income trust structure is necessary, it appears that the response will have to take the form of legislation. Because the challenges posed by an income tax regime that applies inconsistent treatment to equivalent legal entities, economic claims, and cash flows are not unique to Canada, I will briefly review how Australia and the United States approach the issues raised by the income trust structure.

Australia: Entity Classification

In August 1998, the Australian government published an ambitious series of proposals for comprehensive business tax reform, including specific reforms relating to the taxation of entities.¹⁰⁰ A special committee, the Review of Business Taxation, chaired by John Ralph ("the Ralph committee"), was set up to examine the strategies specified in the proposals and to consult widely on the issue of reform. Following the release of two discussion papers¹⁰¹ and an information paper,¹⁰² the Ralph committee published its final report in July 1999.¹⁰³

A key reform set out in the August 1998 proposals related to the consistent taxation of entities. Discussion papers summarized this proposed reform as follows:

The Australian legal system offers investors a range of vehicles—various types of companies, partnerships and trusts—through which they may invest or carry on business. These business vehicles offer considerable flexibility in terms of spreading risk, providing collective investment opportunities and limiting liability. It is important to the efficient operation of business that taxpayers are able to choose the business vehicle that is most appropriate to their needs from a commercial perspective, without bias from the business tax system. To this end, the business tax system should operate in a neutral fashion across business entities and, for any entity, across different sources of financing and across alternative forms of profit and capital distributions. . . .

Very different tax treatment currently applies to investments put through different collective vehicles or entities. This means that exactly the same investment in, say, property or a trading activity attracts very different tax treatment simply because it is conducted through a different entity structure. The result is complexity, distortion in investment decisions and high system costs as investors work through the alternatives to achieve a reduced tax impost. . . .

Anti-avoidance provisions have been introduced continually over the years in an attempt to address these problems. The provisions are lengthy and complex—but, in part because of the lack of a clear framework and the *ad hoc* approach to policy development and legislation, have not been able to keep up with the growing use of tax minimisation strategies. The integrity and ease of use of the business tax system suffer as a result. . . .

Given the practical necessity to levy tax on at least some entities as a means of taxing undistributed income and income attributable to non-residents, the investment neutrality principle in *A Strong Foundation* argues for consistent taxation of entities. Consistent taxation of public and private companies, discretionary and fixed trusts, limited partnerships, co-operatives and life insurers would address the current situation where the same investment can attract very different tax treatment simply because it is put through a different entity.

Under the framework proposed by the Government in *A New Tax System*, consistency across these entities would be achieved by simplified and redesigned company taxation. . . . Trusts, for example, would be taxed as far as possible like companies with transitional arrangements applying to avoid an inappropriate impact on existing trusts.¹⁰⁴

After consultations with the private sector on these and other issues, the Ralph committee made the following recommendations for a consistent entity tax regime:

In *A New Tax System*, the Government announced proposals to reform the taxation of entities. They included a consistent regime for taxing the income of entities, full franking of distributions, refundability of imputation credits, reformed tax arrangements for life insurance, consolidation of company groups and a consistent treatment of entity distributions. The Review was given the task of consulting on these proposals and developing detailed proposals for their implementation in the light of these consultations.

A consistent treatment meets the investment neutrality principle of *A Strong Foundation*. The alternative of taxing companies more like trusts, and allowing tax preferences to flow through, is generally not feasible from a revenue viewpoint.

The general principle is that trusts will be subject to the entity tax regime. Consistent with *A New Tax System*, there will be specific exclusions from the regime for trusts created or settled only as a legal requirement or subject to a legal test or sanction. This approach distinguishes such trusts from trusts created at a settlor's direction. Exclusions are also justified in other cases for practical reasons. In particular, bare trusts, constructive trusts, the bank accounts of minors, and stakeholder and purchaser trust arrangements will be excluded.¹⁰⁵

Although the Australian government has moved forward on a number of the Ralph committee's key recommendations, the future of the reforms relating to entity

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taxation is uncertain. In the face of significant opposition from farmers, business groups, and its own backbenchers, the Australian government recently announced that it was shelving the reforms relating to entity taxation:

A pledge by the Coalition to crack down on the use of trusts to avoid tax has been rejected by the Howard Government's own advisory body, which will instead recommend only minor legal changes to curb abuse.

In a victory for private businesses, farmers and wealthy individuals who use trusts, the Board of Taxation has rejected a central recommendation of the 1999 Ralph business tax review—to tax the country's 450,000 trusts as companies, a move that was forecast to reap \$350 million a year in extra revenue.

After a year-long review, board chairman Dick Warburton said the advisory body would propose that tax laws governing trusts be better enforced. . . . The board was asked by Peter Costello to examine the best legislative means to prevent abuse of trusts, but has taken more than 12 months to conclude legislation is unnecessary. . . . [T]he abuse of trusts is estimated to be costing hundreds of millions a year.

Mr Warburton, a business leader and member of the Reserve Bank board, said the use of trusts was part of mainstream society. While the Board of Taxation recognised there were some abuses, it could not quantify them. "It really has proved more difficult to find exactly where abuses of trusts occur that don't impinge on regular usage," he said. "The more you look at it, trusts are legitimate ways to do business."¹⁰⁶

The Australian debate exhibits some parallels with the Canadian debate on income trusts. As noted in the extract quoted above, the "abuse" of trusts is estimated to cost hundreds of millions of dollars, and yet it is difficult to identify these that are abusive.

The United States: Treatment of Corporate Equivalents (Limited Liability Corporations and S Corporations)

As previously noted, the income trust structure allows the owners of a taxable operating business to retain many of the non-tax advantages of the corporate form while largely avoiding the negative tax consequences. A similar result is achieved in the United States through the use of limited liability companies (LLCs), S corporations, and other forms of unincorporated entities which can elect to be taxed as a partnership (that is, as a flowthrough entity). Over the last 20 years, many states have adopted limited liability statutes that permit businesses to have "all of the non-tax characteristics of corporations (included limited liability for all investors) while technically not being corporations."¹⁰⁷ The incentive to create unincorporated substitutes for corporations is arguably stronger in the United States than it is in Canada because the US corporate tax system is considered a "classical" system, in which the corporation is taxed as a separate entity from its shareholders with, generally, no recognition at the shareholder level for tax paid by the corporation (except in the case of S corporations).¹⁰⁸

As a result of the development of LLCs and other forms of unincorporated corporate substitutes, the US Congress has adopted a regime that allows most¹⁰⁹

forms of (unincorporated) businesses to elect to be taxed either as a partnership or as a corporation, with the default rule being partnership treatment.

However, there is an important distinction between the current tax treatment of corporate equivalents such as LLCs in the United States and the treatment of the income trust in Canada. Section 7704 of the Internal Revenue Code¹¹⁰ provides that publicly traded partnerships (which includes LLCs and similar entities that are taxable as partnerships) will be taxed as corporations if their interests are traded on an established securities market or if the interests are readily tradeable on a secondary market.¹¹¹ Similarly, S corporations (which generally do not pay income tax) are subject to various restrictions that effectively exclude public tradeability: the number of shareholders cannot exceed 75; no non-resident alien may be a shareholder; and all shareholders must be individuals, estates, or certain permitted trusts, certain permitted employment-related plans, or charitable organizations.¹¹²

Although the US approach to corporate substitutes is attractive to those concerned about preserving the corporate tax base, it can offer only limited guidance to policymakers in Canada. The Income Tax Act expressly creates a regime for a publicly traded entity that receives flowthrough treatment. Indeed, it is a requirement for qualification as a mutual fund trust that its securities have been distributed under prospectus. Consequently, any movement in the direction of the US position will require a fundamental revisiting of the mutual fund regime in the Act.

Specific Measures Aimed at Tax-Exempts

As was noted earlier in this article, the growing role of tax-exempts in the financing activities of taxable Canadian businesses and the preference of tax-exempts for debt are key factors in the proliferation of the income trust structure. One way to address the challenges posed by the income trust structure is to introduce specific measures aimed at tax-exempts—for example, restrictions on the ability of tax-exempts to participate in the financing of taxable Canadian businesses, or restrictions on the extent to which certain tax-exempts enjoy a general exemption from tax. At the extreme, certain categories of tax-exempts (such as pension plans and deferred income plans) could cease to be tax-exempt entirely.¹¹³

In the present climate, however, any such measures appear unlikely. Restrictions on or elimination of the ability of tax-exempts to participate in financing activities would not be revenue-neutral, and thus would not be imposed except as part of a much broader overhaul of the income tax system. A targeted measure in isolation would face significant public opposition similar to that encountered by the Australian entity classification reforms. Indeed, it is probably fair to say that the tax-exempt status of pension plans and RRSPs has become the “third rail” of the income tax system—touch it and you die.

But even if this were not the case, we would still face the fundamental problem of identifying what sources of income would be subject to restriction and what sources would continue to be exempt.¹¹⁴ For example, it would be difficult to justify continued exempt status for investments in traditional forms of royalty and income trusts (that is, in the resource and real estate sectors) while introducing restrictions

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on investments in non-traditional sectors. The structures are not dissimilar; it is the application of an existing structure to a new area that is novel. For these and other reasons, the Mintz committee recommended that issues relating to the erosion of the corporate tax base "should not be dealt with by any new tax at the investor level, nor by any limitation on current tax rules determining exempt status."¹¹⁵

A Full Integration Model for Public Company Dividends

Because the income trust structure allows for the creation of a tax-advantaged form of equity that permits a distribution of earnings through a dividend-like payment that is deductible to the payer, why not simply allow taxpayers to achieve this result directly through the adoption of a full-integration regime for public corporations? Indeed, the recent interest in the income trust structure has been accompanied by calls for the elimination of the double taxation on dividends paid by public corporations (that is, for a move to a full integration model).¹¹⁶

It is unlikely, however, that Finance will expand the degree of integration. First, to the extent that Finance determines that a legislative response is necessary, the response is likely to be motivated by a desire to stem the revenue losses that result from increased use of the income trust structure. Extending the full integration system beyond CCPCs would almost certainly have the opposite effect.

Second, the possibility of extending the level of integration for corporations other than CCPCs was considered and rejected (for the near term, at least) by the Mintz committee. Although the committee concluded that the partial integration provided for in the Canadian income tax system generates important economic benefits,

the level of relief provided under the partial integration system in Canada is appropriate at this time. While expanding integration could offer substantial economic benefits, the revenue costs to governments would be large, and the heavy reliance of the Canadian economy on foreign capital would blunt some of the positive effects. Nevertheless, the Committee believes that, over time, and as circumstances permit, some consideration should be given to increasing the level of integration of corporate and personal income tax in Canada.¹¹⁷

Although some observers have criticized the timidity of this recommendation,¹¹⁸ it seems likely that Finance will take its cue from the Mintz report.

Expansion of the Thin Capitalization Rules for Corporations

The Mintz committee noted that the concerns related to the erosion of the corporate tax base could be addressed by limiting or denying the deduction for interest in certain circumstances:

Solutions that could be considered at the corporate level include limiting or denying the deduction of some otherwise deductible amounts, such as interest, based on an earnings stripping or thin capitalization type of test. There would, of course, be significant technical and practical difficulties with such an approach. In addition to

the problem of identifying which payments would be subject to limitation of deduction, it would be necessary to have tracking rules to deal with amounts flowing to investors through intermediaries. The latter would add administrative complexity and could be difficult to manage in cases where the intermediary was widely held.¹¹⁹

Aside from the "significant technical and practical difficulties," limitations on interest deductibility could not be confined to the income trust. As the Mintz committee noted, the use of trusts to reduce corporate-level tax does not represent a new approach to structuring business investment.¹²⁰ Any legislative response aimed at limiting or denying the deduction of interest in the income trust context is likely to require a general amendment to the rules relating to the deductibility of interest.

CONCLUSION

The popularity of the income trust structure is in large part attributable to the fact that it allows the owners of a taxable corporation to retain many of the non-tax advantages of the corporate form while avoiding the negative tax consequences—principally, of double taxation of income, once at the corporate level and again at the individual shareholder level. The federal dividend tax credit allows individual shareholders to recover only a portion of the tax paid by the corporation on the income that generated the dividend. The unrecovered portion represents an absolute tax cost associated with the use of a corporation.

The income trust structure "bundles" features of debt and equity in the securities offered to the public. Essentially, the structure is a tax-advantaged form of equity that permits a tax-efficient dividend (that is, a distribution of earnings in the nature of a dividend that is deductible to the payer). The use of high-yield debt as a substitute for equity at the corporate level allows for the creation of a deductible interest expense that is intended to substantially reduce if not eliminate tax at the corporate level.

The proliferation of the income trust raises a number of tax policy questions. First, the income trust financing structure may lead to a substantial erosion of the corporate tax base. If the income trust sector continues to expand at current rates, Finance officials may act to protect the corporate tax base. A second and perhaps more troubling concern relates not to the structure per se but rather to what the popularity of the structure says about the Canadian income tax system. I have argued throughout this article that the proliferation of the income trust highlights a serious flaw in the system—namely, the failure to apply a coherent and consistent treatment to legal entities, economic claims, and cash flows that may differ in form but that are equivalent in substance.

It makes little sense, for example, for a tax regime to apply one set of rules to the corporate form and a substantially different set of rules to an equivalent form such as a mutual fund trust imbued with corporate attributes. The income trust structure raises concerns not only about efficiency, but also about the policy goals of simplicity and neutrality. The complexity of the income trust is of particular concern, since some investors—particularly retail investors—may not fully appreciate that

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INCOME TRUSTS ■ 1561

they are purchasing a product that is packaged as a fixed-income product but that in many cases resembles, in economic terms, an equity claim. If investors are being misled about the fundamental nature of their investment, then the Act is complicit in this deception.

I have examined a number of possible policy responses to the issues raised by the income trust structure. Unfortunately, it is far from clear that there is any consensus about what the objectives of reform should be or how to achieve those objectives even if they could be agreed upon.

It is unlikely that the current popularity of the income trust structure will fade. The same factors that have contributed to its growth—the increasing role of tax-exempts in financing taxable Canadian businesses and the substantial tax savings that can be achieved by substituting debt for equity—suggest that the income trust structure is here to stay.

Similarly, it is unlikely that a court challenge to the income trust structure will meet with much success. The Supreme Court has consistently held that when a transaction is legally effective and is not otherwise a sham, the court must respect the legal form of the transaction without regard to the underlying economic purpose, even if that purpose is to reduce tax. Consequently, it appears that some form of legislative response is not only necessary but inevitable.

NOTES

- 1 In terms of the Canadian equity new issues market by value, income trusts represented 4 percent of the new issues market in 2000; 15 percent in 2001, and 25 percent in 2002. See R.D. Brown, "Practical Issues in Investing In and Managing Income Trusts," in *The Canadian Institute's National Summit on Income Trusts* (Toronto: Canadian Institute, November 2002).
- 2 A. Willis, "Income Trust Bubble Needs a Good Jab," *Globe and Mail*, April 17, 2002.
- 3 P. Viera, "Income Trusts Fuelling IPO Explosion," *National Post*, July 9, 2002, and A. Barnes, "Income Trusts Boost Number of IPOs," *Globe and Mail*, July 9, 2002. The PricewaterhouseCoopers study, "Survey Shows IPO Market Strong Despite Larger Market Woes," is available at <http://www.pwcglobal.com/> (search on title of study).
- 4 S. Rubin, "Ottawa Faces \$1B in Lost Tax," *National Post*, August 15, 2002.
- 5 S. Maich, "TSX's Future Could Lie in Trusts: Bissett," *National Post*, May 30, 2002.
- 6 See, for example, the prospectus filed by Connors Bros. Income Fund, October 26, 2001. This prospectus, and the other prospectuses referred to in the following notes, are available at <http://www.sedar.com>.
- 7 See, for example, the prospectus filed by A & W Revenue Royalties Income Fund, February 8, 2002.
- 8 See, for example, the prospectus filed by The Keg Royalties Income Fund, dated May 21, 2002.
- 9 See, for example, the prospectus filed by Sun Gro Horticulture Income Fund, dated March 19, 2002.
- 10 See, for example, the prospectus filed by Davis + Henderson Income Fund, dated March 18, 2002.
- 11 See, for example, the prospectus filed by Versacold Income Fund, dated February 5, 2002.
- 12 See, for example, the prospectus filed by General Donlee Income Fund, dated April 24, 2002.
- 13 See, for example, the amended preliminary prospectus filed by Swiss Water Decaffeinated Coffee Income Fund, dated April 18, 2002.

- 14 See, for example, the amended preliminary long-form prospectus filed by Prime Restaurants Royalty Income Fund, dated June 19, 2002.
- 15 Rudy Luukko, "Income Trusts' Big Tax Benefits," *Globe and Mail*, April 15, 2001.
- 16 This statement may not be true for every income trust structure, because not all income trust structures involve the use of a corporation as an operating entity. However, the statement is generally true for most income trusts, particularly in the business income trust context. This conclusion is noted in Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998) (the Mintz report), 7.20, note 18: "The income or royalty trust combines the advantages of the lack of personal liability and the liquidity of individual investment interests that are usually associated with the shares of an incorporated company with the tax advantages of an unincorporated business."
- 17 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.
- 18 Rubin, *supra* note 4.
- 19 As noted above, this paper makes reference to the General Donlee Income Fund IPO as an illustration of the recent trend toward so-called business income trusts (that is, the application of the income trust structure to a non-traditional business sector). Although I will suggest in this paper that the income trust form (particularly in some of its more complicated manifestations) potentially raises concerns with respect to whether investors fully understand the product, I do not wish to suggest that the Donlee transaction represents an example of this concern. It should be noted that, in structural terms, the General Donlee transaction represents one of the simpler income trust transactions. Moreover, the General Donlee Income Fund prospectus contains a detailed description of the nature of the units at page 52 and elsewhere.
- 20 In view of the current trend toward the use of the income trust as a tax-efficient corporate substitute, I will focus on the income trust structure as opposed to the royalty trust structure. For a description of the royalty trust structure, see, for example, John A. Brussa, "Royalty Trusts, Income Trusts, and the Search for Yield: A Phenomenon of a Low-Interest-Rate Environment?" in *Report of Proceedings of the Forty-Eighth Tax Conference, 1996 Conference Report*, vol. 1 (Toronto: Canadian Tax Foundation, 1997), 19:1-27. See also John A. Brussa, "Royalty Trusts" (1997) vol. 35, no. 2 *Alberta Law Review* 314-33. See also J.T. Bruvall and S.R.W. Goetz, "The Critical Success Factors for Oil and Gas Royalty Trusts," in *National Summit on Income Trusts*, *supra* note 1.
- 21 See, for example, S. Maich, "Stocks in Deepest Funk 'in 30 Years,'" *National Post*, June 8, 2002. The Dow Jones Industrial average peaked at 11,722.98 on January 14, 2000. On September 27, 2002, the DJIA closed at 7701.4. On March 10, 2000 the NASDAQ peaked at 5,132.52. On September 27, 2002, the NASDAQ closed at 1199.16. The TSE 300 peaked at 11,388.80 on September 1, 2000. On September 27, 2002, the S & P/TSX Composite Index closed at 6,111.11.
- 22 It should be noted that interest in the income trust structure is not restricted to issuers that seek to effect a financing. A corporate issuer that is not in need of financing may still wish to convert into an income trust to reduce or eliminate a substantial corporate tax liability, which should therefore have the effect of raising its share price. Recent corporate "conversions" into trusts include Parkland Industries Ltd., Welco Energy Services Inc., and Transforce Inc.
- 23 Brussa, 1996 Conference Report, *supra* note 20, at 19:3.
- 24 If a corporation distributes earnings in the form of a dividend, the dividend is taxable as ordinary income to the recipient at the time of distribution. Although the recipient may be entitled to claim a credit (the dividend tax credit) to reflect a portion of the corporate tax paid by the payer, the taxation of the corporate earnings as income is nevertheless less favourable than the corresponding capital gains treatment potentially available if the corporation retains the earnings. If the corporation chooses to retain its earnings, the retained earnings should in theory be reflected in the stock price. Shareholders should, again in theory, be able to realize

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the same economic gain that they would have received had the earnings been distributed as dividends. However, by receiving the earnings on the sale of the shares, the shareholder is able to defer the income inclusion until the time of sale (since capital gains are generally taxed on a realization basis) and to benefit from the significantly preferential treatment accorded to capital gains. In Canada, the capital gains inclusion rate is currently 50 percent.

- 25 Because interest is ordinarily considered an expense, it may seem odd to refer to a distribution of earnings in the form of "interest." However, I will argue that the interest expense that is central to the income trust structure is in substance a distribution of earnings.
- 26 Under the Act, a distribution of cash in the form of a dividend is relatively tax-inefficient in comparison with other methods of income distribution: except in limited circumstances, the Act fails to ensure complete "integration" when dividends are paid. This is discussed below.
- 27 For a discussion of this principle, see, for example, William A. Klein and John C. Coffee Jr., *Business Organization and Finance: Legal and Economic Principles*, 6th ed. (New York: Foundation Press, 1996), 357 et seq.
- 28 A recent article describes this phenomenon as follows: "Fifty years ago, dividend yields in the U.S. were typically 6%. Now they are barely above 1%. Since the early 1980s, dividends have been on a steady 'down-draft,' said Doug Porter, a BMO Nesbitt Burns economist. On average, the yield for firms in the TSX composite troughed at 1% when the market peaked, down from a non-inflation-adjusted 4.5% in the late 1970s." L. Karloff, "Big Tax Bite Behind Move to Trusts," *National Post*, August 16, 2002.
- 29 See, for example, Richard A. Posner, *Economic Analysis of Law*, 5th ed. (New York: Aspen Publishers, 1998), 453; and Frank H. Easterbrook, "Two Agency-Cost Explanations of Dividends" (1984) vol. 74, no. 4 *The American Economic Review* 650-59.
- 30 For further discussion on this point, see W. Lilley, "The Matter of Trusts," *National Post Business*, October 2002.
- 31 Peter Lee, "The Attractiveness of Income Funds," in *Focus on Income Funds*, a special edition of the *Blakes Report* (April/May 2002), available at <http://www.blakes.com>.
- 32 For a discussion of this principle, see, for example, Klein and Coffee, *supra* note 27, at 338 et seq.
- 33 For a discussion of this principle, see, Klein and Coffee, *ibid.*, at 334-36.
- 34 SEDAR is the Canadian securities regulators' System for Electronic Document Analysis and Retrieval. The SEDAR site is at <http://www.sedar.com>.
- 35 Prospectus filed by General Donlee Income Fund, *supra* note 12, available at <http://www.sedar.com> (herein referred to as "the Donlee prospectus"), 4-5 of the prospectus summary.
- 36 *Ibid.*, at 25.
- 37 The Donlee prospectus also indicates that some of the proceeds of the offering would be used to repay indebtedness to the GD security holders.
- 38 The Donlee prospectus, at 25.
- 39 The Donlee prospectus indicates that, in certain circumstances (that is, if the offering was less successful than anticipated), a certain number of units of the fund would be issued to the GD security holders as partial consideration for the purchase price, and the GD security holders would retain an interest in General Donlee. However, if demand was sufficient, the underwriters would exercise an overallotment option to purchase from treasury a specified number of additional units, the proceeds of sale of which would be paid to the GD security holders in lieu of the retained interest. Subsequent filings indicate that the overallotment option was fully exercised. Accordingly, it appears that the GD security holders have fully disposed of their holdings. See the Donlee prospectus, at 25-27 and 42-44.
- 40 The prospectus states that, upon the completion of the offering, the following will occur: "Immediately following the closing of the Offering, the Fund will acquire from the GD Securityholders all of the Donlee Securities in return for cash. . . . Following the acquisition of

the Donlee Securities by the Fund, the Fund will subscribe for the Donlee Notes and the Donlee Securities will be transferred to a subsidiary of the Fund, which will, in turn, amalgamate with General Donlee. Following such amalgamation, the Fund will own all of the Common Shares of General Donlee and all of the Donlee Notes." *Ibid.*, at 25.

- 41 *Ibid.*, at 35. Not all of these costs are attributable to the fact that a second tier (the trust) has been added. Many of the costs are attributable to the fact that GDL is now, in substance, a public entity, and they would have been incurred in any event had GDL made a public offering directly.
- 42 *Ibid.*, at 28.
- 43 "Integration" refers to the tax policy objective of seeking to ensure that the tax system remains neutral with respect to the form of business organization used by ensuring that "the total tax paid by a corporation and its shareholders (is) equal to the total tax paid by an individual who carries on the same economic activity directly and not through the corporation." See, for example, Robert E. Beam, Stanley N. Laiken, and James J. Barnett, *Introduction to Federal Income Taxation in Canada*, 22d ed. (Toronto: CCH Canadian, 2001), 662. See also, for example, Howard J. Kellough and Peter E. McQuillan, *Taxation of Private Corporations and Their Shareholders*, 3d ed. (Toronto: Canadian Tax Foundation, 1999), 2:3 et seq., and the Mintz report, *supra* note 16, at 7.2 et seq.
- 44 Defined in subsection 89(1).
- 45 Beam, Laiken, and Barnett, *supra* note 43, at 665.
- 46 The Mintz report, *supra* note 16, at 7.14.
- 47 Thomas E. McDonnell, *Tax-Exempt Organizations and the Financing of Taxable Businesses: An Examination of Canadian Tax Policy Issues*, Working Paper 97-9 prepared for the Technical Committee on Business Taxation (Ottawa: Department of Finance, November 1997), 1.
- 48 It should be noted that in contrast to certain other classes of tax-exempts, such as Crown corporations, municipal authorities, and registered charities, the tax exemption available to deferred income plans such as registered pension plans and RRSPs represents a deferral rather than an absolute exemption, since ultimately the income will be subject to tax at the time of distribution to plan beneficiaries.
- 49 The Mintz report, *supra* note 16, at 7.14.
- 50 *Ibid.*, at 7.20, note 19.
- 51 *Ibid.*, at 7.14-15.
- 52 From a tax-planning perspective, the optimal investment strategy for tax-exempts such as a pension plan or a deferred income plan is to acquire a business directly (perhaps retaining the existing management to manage the business). However, pension plans and deferred income plans are generally restricted from carrying on business directly and may become subject to tax if they invest in non-qualified property or hold foreign property in excess of prescribed limits. Deferred income plans are generally restricted to passive investments, such as the following:
 - money;
 - certain bonds and debt obligations of or guaranteed by certain governments;
 - bonds and debt obligations issued or guaranteed by corporations listed on prescribed stock exchanges;
 - shares listed on prescribed stock exchanges;
 - shares and debt of "public corporations";
 - a unit of a "mutual fund trust";
 - a mortgage insured under the National Housing Act;
 - a royalty unit listed on a prescribed exchange in Canada, which derives its value from Canadian resource properties; and
 - a limited partnership unit listed on a stock exchange.

For a further discussion along these lines, see McDonnell, *supra* note 47, at 9 et seq.

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INCOME TRUSTS • 1565

- 53 For a description of the basic mechanics of an income fund structure, see McDonnell, *supra* note 47, at 13-14.
- 54 These steps are described at page 25 of the Donlee prospectus.
- 55 It is not clear from the prospectus whether there are any business reasons (other than tax planning) for this step. On the one hand, the replacement of the existing equity claim (the Donlee securities previously held by the GD security holders) with a debt-and-equity mix appears, *prima facie*, to provide some measure of additional security to the public investors, because at least part of their claim on the assets and earnings of GDL will rank *pari passu* with the claims of other unsecured creditors. However, the prospectus (*supra* note 12, at 29) states that the Donlee notes are "subordinate in right of payment to other indebtedness of General Donlee." This suggests that the additional security is limited at best.
- 56 See the note indenture dated May 3, 2002, at 1.
- 57 The pro forma consolidated balance sheet of the fund in the Donlee prospectus states (at page F-32) that the total consideration to be paid by the fund in connection with the acquisition of GDL is \$82,952,000.
- 58 The prospectus describes the Donlee notes as follows: "The Donlee Notes will be unsecured debt obligations of General Donlee and be subordinate in right of payment to other indebtedness of General Donlee (directly or by guarantee) for borrowed money or performance bonds, to personal property leases and other secured financings and to certain other obligations that General Donlee may designate from time to time. In addition, the Donlee Notes are subject to any security interest granted and existing by the Fund in respect of the Donlee Notes in favour of the holder or holders of such indebtedness." *Ibid.*, at 29.
- 59 The concluding words of paragraph 20(1)(c), which provides an express deduction for "interest," restrict the deduction to the actual amount of the deduction "or a reasonable amount in respect thereof, whichever is the lesser."
- 60 The parties to the Donlee transaction will almost certainly have obtained appropriate opinions from a dealer or similar entity confirming that the rate of 15.82 percent per annum represented a commercially reasonable rate of interest at the time of the transaction. These opinions are likely to be based on comparable high-yield debt financings in Canada and the United States and on the fact that, at the time of the Donlee transaction, comparable income trust transactions were offering yields in the area of 14.5 percent per annum. Given that an income trust unit, in addition to its debtlike features, also contains a potential for equity appreciation, it is perhaps not unreasonable for a pure debt offering (which would not contain this equity upside potential) to command a higher yield.
- 61 A further alternative could include "stapling" the common shares to the debt:
 "Stapled" alternative: In 1998, TimberWest unwound its trust structure and distributed "stapled" shares and notes of the operating subsidiary to the unitholders. This avoided the foreign ownership limits while apparently preserving the tax benefits, and reducing the complexity. This may be a model worth considering in more detail.
 See S. Romano, "New Developments, Emerging Trends and the Future of Income Trusts in Canada," in *National Summit on Income Trusts*, *supra* note 1.
- 62 This term is defined in subsection 108(2).
- 63 Subsection 132(6).
- 64 Subsection 104(6).
- 65 Paragraph 108(2)(a) reads as follows:
 (2) For the purposes of this Act, a trust is a unit trust at any particular time if, at that time, it was an *inter vivos* trust the interest of each beneficiary under which was described by reference to units of the trust, and

(a) the issued units of the trust included

(i) units having conditions attached thereto that included conditions requiring the trust to accept, at the demand of the holder thereof and at prices determined and payable in accordance with the conditions, the surrender of the units, or fractions or parts thereof, that are fully paid, or

(ii) units qualified in accordance with prescribed conditions relating to the redemption of the units by the trust,

and the fair market value of such of the units as had conditions attached thereto that included such conditions or as were so qualified, as the case may be, was not less than 95% of the fair market value of all of the issued units of the trust (such fair market values being determined without regard to any voting rights attaching to units of the trust).

66 Paragraph 108(2)(b) reads as follows:

(2) For the purposes of this Act, a trust is a unit trust at any particular time if, at that time, it was an *inter vivos* trust the interest of each beneficiary under which was described by reference to units of the trust, and . . .

(b) each of the following conditions was satisfied:

(i) throughout the taxation year that includes the particular time (in this paragraph referred to as "the current year"), the trust was resident in Canada,

(ii) throughout the period or periods (in this paragraph referred to as the "relevant periods") that are in the current year and throughout which the conditions in paragraph (a) are not satisfied in respect of the trust, its only undertaking was

(A) the investing of its funds in property (other than real property or an interest in real property),

(B) the acquiring, holding, maintaining, improving, leasing or managing of any real property, or interest in real property, that is capital property of the trust, or

(C) any combination of the activities described in clauses (A) and (B),

(iii) throughout the relevant periods at least 80% of its property consisted of any combination of

(A) shares,

(B) any property that, under the terms or conditions of which or under an agreement, is convertible into, is exchangeable for or confers a right to acquire, shares,

(C) cash,

(D) bonds, debentures, mortgages, notes and other similar obligations,

(E) marketable securities,

(F) real property situated in Canada and interests in such property, and

(G) rights to and interests in any rental or royalty computed by reference to the amount or value of production from a natural accumulation of petroleum or natural gas in Canada, from an oil or gas well in Canada or from a mineral resource in Canada,

(iv) either

(A) not less than 95% of its income for the current year (computed without regard to subsections 49(2.1) and 104(6)) was derived from, or from the disposition of, investments described in subparagraph (iii), or

(B) not less than 95% of its income for each of the relevant periods (computed without regard to subsections 49(2.1) and 104(6) and as though each of those periods were a taxation year) was derived from, or from the disposition of, investments described in subparagraph (iii),

(v) throughout the relevant periods, not more than 10% of its property consisted of bonds, securities or shares in the capital stock of any one corporation

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INCOME TRUSTS ■ 1567

or debtor other than Her Majesty in right of Canada or a province or a Canadian municipality, and

(vi) where the trust would not be a unit trust at the particular time if this paragraph were read without reference to this subparagraph and subparagraph (iii) were read without reference to clause (F), the units of the trust are listed at any time in the current year or in the following taxation year on a prescribed stock exchange in Canada.

- 67 Brussa, 1996 Conference Report, *supra* note 20, at 19:7.
- 68 Douglas A. Cannon, "Income Trusts: The Interest (Deduction) Continues—A Review of Westshore Terminals Income Fund and Superior Propane Income Fund," in *Current Issues in Corporate Finance*, 1997 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1998), 4:1-28, at 4:22.
- 69 For a discussion of the issues relating to the right of redemption, see Cannon, *ibid.*, at 4:22-23.
- 70 The Donlee prospectus, *supra* note 12, at 38.
- 71 See also Brussa in the 1996 Conference Report, *supra* note 20, at 19:8-9. See also R. Lewin, "Income Tax Issues Relating to the Income Trust," in *National Summit on Income Trusts*, *supra* note 1.
- 72 The attributes of GDI, common shares and fund units are described in the prospectus, *supra* note 12, at 27 and 36, respectively. See also Lilley, *supra* note 30.
- 73 See the prospectus, *ibid.*, at 39 et seq.
- 74 The prospectus states that statutory directors' duties have been built into the Trust Indenture: "The Declaration of Trust provides that the Trustees shall act honestly and in good faith with a view to the best interests of the Fund and in connection therewith shall exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. The Declaration of Trust provides that a Trustee shall individually be entitled to indemnification from the Fund in respect of the exercise of his or her powers and the discharge of his or her duties provided that he or she shall not be indemnified if he or she failed to act in good faith with a view to the best interests of the Fund. Additionally, in certain circumstances, limitations on indemnification similar to those applicable to a director under the *Canada Business Corporations Act* will apply. General Dunlee will also agree to indemnify the Trustees provided they act honestly and in good faith with a view to the best interests of the Fund and in connection therewith shall exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances." *Ibid.*, at 37.
- 75 Rubin, *supra* note 4.
- 76 See, for example, Match, *supra* note 5; A. Willis, P. Waldie, and E. Reguly, "Hydro Income Trust 'a Dumb Idea,'" *Globe and Mail*, May 3, 2002; and F. Taylor, "Vox: Do Your Homework on Income Trusts," *Globe and Mail*, May 3, 2002.
- 77 Brussa, 1996 Conference Report, *supra* note 20, at 19:3.
- 78 Lunkko, *supra* note 15.
- 79 Brussa, 1996 Conference Report, *supra* note 20, at 19:3.
- 80 For example, the Donlee prospectus indicates at page 9 that "[s]ubstantially all of such amount [distributed cash] will be considered income of the Unitholder for Canadian tax purposes."
- 81 See, for example, I. Karloff, "Enjoy Your Steak, Skip the Funds," *National Post*, November 22, 2002; and D. DeCioet, "Not All Income Trusts Are Equal," *National Post*, November 15, 2002.
- 82 For further discussion on this issue, see Romano, *supra* note 61, and S.L. Erlichman, "Income Trusts: Some Legal Considerations," in *National Summit on Income Trusts*, *supra* note 1. This appears to be the reason for the current exclusion of income trusts from the S & P/TSX composite index: P. Fitzpatrick, "Trusts Shut Out of TSX Benchmark," *National Post*.

November 12, 2002. See P. Haavardsrud and G. Marr, "S & P Considers Adding Income Trusts to Index," *National Post*, August 24, 2002.

- 83 See the prospectus, *supra* note 12, at 53: "The Declaration of Trust provides that no Unitholder will be subject to any liability whatsoever to any person in connection with a holding of Units. However, there remains a risk, which is considered by the Fund to be remote in the circumstances, that a Unitholder could be held personally liable despite such statement in the Declaration of Trust, for the obligations of the Fund to the extent that claims are not satisfied out of the assets of the Fund. It is intended that the affairs of the Fund will be conducted to seek to minimize such risk wherever possible."
- 84 The Donlee prospectus indicates (at page 26) that, following closing, GDL will establish a new senior secured credit facility, which will be supported by a guarantee from the fund. Typically, where an income trust provides a guarantee, the guarantee is limited contractually to the fund's assets, and the lender is expressly precluded from seeking recourse against the trustees or beneficiaries. It appears that the GDL credit facility will be typical in this regard. See the Donlee prospectus, page 53.
- 85 For example, under the Ontario Business Corporations Act, RSO 1990, c. B.16, as amended, it is not possible to contract out of the provisions relating to a shareholder's right to bring a derivative or oppression action. However, the prospectus (*supra* note 12, at 52) states that unitholders will not have these rights (that is, these corporate attributes have not been built back into the structure).
- 86 See, for example, McDonnell, *supra* note 47, at 97-99.
- 87 *Ibid.*, at 20.
- 88 See, for example, Rubin, *supra* note 4.
- 89 *Ibid.*
- 90 For a discussion of this principle, see, for example, Klein and Coffee, *supra* note 27, at 336 et seq.
- 91 The concluding words of paragraph 20(1)(c), which provides an express deduction for "interest," restrict the deduction to the actual amount of the deduction "or a reasonable amount in respect thereof, whichever is the lesser."
- 92 This is discussed further in the next section of the article. For recent commentary on the Supreme Court's views on tax avoidance, see, for example, Brian J. Arnold, "Reflections on the Relationship Between Statutory Interpretation and Tax Avoidance" (2001) vol. 49, no. 1 *Canadian Tax Journal* 1-39, at 14 et seq.
- 93 The courts have traditionally accepted the characterization of a payment as interest if the payment meets the following "essential characteristics":
 - it is compensation paid for the use of another's money,
 - it is referable to a principal in money or an obligation to pay money, and
 - there is a day-to-day accrual of interest.

These principles are found in the decisions of the Supreme Court in *Reference as to the Validity of Section 6 of the Farm Security Act, 1944, of the Province of Saskatchewan*, [1947] SCR 394, and *Aty-Gen. for Ontario v. Barfried Enterprises Ltd.*, [1963] SCR 570. The application of these principles in the income trust context is considered in Cannon, *supra* note 64, at 4:8-13. For a general discussion of these principles, see Brian J. Arnold and Tim Edgar, "Deductibility of Interest Expense" (1995) vol. 43, no. 5 *Canadian Tax Journal* 1216-44.
- 94 Cannon, *supra* note 68, at 4:13.
- 95 See, for example, Arnold, *supra* note 92, at 14 et seq.
- 96 *Inland Revenue Commissioners v. Westminster (Duke)*, [1936] AC 1, at 19 (HL).
- 97 (1999), 178 DLR (4th) 26 (SCC).
- 98 *Ibid.*, at paragraphs 45-46.

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INCOME TRUSTS ■ 1569

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- 99 When the Supreme Court released its decision in *Sbell Canada* in October 1999, there was some question whether the decision had limited precedential value because the language of section 245 had since been replaced with the much more substantial (and ominous-sounding) GAAR. However, early signs are that the direction taken by the Supreme Court in the *Sbell* case will be followed in cases decided under the new section 245.
- 100 Australia, *Tax Reform: Not a New Tax, a New Tax System* (Canberra: Australian Government Publishing Services, August 1998), herein referred to as "the August 1998 proposals."
- 101 Australia, *Review of Business Taxation, A Strong Foundation: Establishing Objectives, Principles and Processes* (Canberra: Australian Government Publishing Services, November 1998); and Australia, *Review of Business Taxation, A Platform for Consultation—Building on a Strong Foundation* (Canberra: Australian Government Publishing Services, February 1999). The first discussion paper is reviewed in the Current Tax Reading feature (1999) vol. 47, no. 1 *Canadian Tax Journal* 164-79, at 172.
- 102 Australia, *Review of Business Taxation, An International Perspective: Examining How Other Countries Approach Business Taxation* (Canberra: Australian Government Publishing Services, December 1998) (available at <http://www.rbt.treasury.gov.au>).
- 103 Australia, *Review of Business Taxation, A Tax System Redesign: More Certain, Equitable and Durable* (Canberra: Australian Government Publishing Services, July 1999) (available at <http://www.rbt.treasury.gov.au>), herein referred to as "the Ralph report."
- 104 "Overview," *A Platform for Consultation*, supra note 95, at paragraphs 182, 184, 192, and 198-99.
- 105 "Overview," *A Tax System Redesign*, supra note 97, at paragraphs 276-78.
- 106 S. Lewis, "Trusts Tax Reform 'Too Hard,'" *Daily Telegraph* (Sydney), August 29, 2002.
- 107 Howard E. Abrams and Richard L. Doernberg, *Federal Corporate Taxation*, 4th ed. (New York: Foundation Press, 1998), 55 et seq.
- 108 *Ibid.*, at 7 et seq.; see also Kellough and McQuillan, *infra* note 118, at 22:2.
- 109 Exceptions include "heavily regulated entities such as insurance companies and banks, entities wholly owned by a state or municipality, and a variety of foreign business entities traditionally treated as corporations under domestic and foreign laws." See Abrams and Doernberg, *supra* note 101, at 55.
- 110 Internal Revenue Code of 1986, as amended.
- 111 Abrams and Doernberg, *supra* note 107, at 55.
- 112 *Ibid.*, at 311.
- 113 This would not be unprecedented. It is interesting to note that in the mid-1990s, New Zealand significantly altered the tax treatment of pension contributions. No deduction is allowed for employee contributions; although employers are allowed a deduction for employer contributions, employees are essentially taxed on these contributions. See, for example, Satya Poddar and Morley D. English, "Canadian Taxation of Personal Investment Income" (1999) vol. 47, no. 5 *Canadian Tax Journal* 1270-1304, at 1298.
- 114 The Mintz report, *supra* note 16, at 7.16.
- 115 *Ibid.*
- 116 Kardeff, *supra* note 28.
- 117 The Mintz report, *supra* note 16, at 7.4.
- 118 For example, Howard J. Kellough and Peter E. McQuillan, "Integration Revisited: Coordinating the Corporate and Personal Tax Systems," in *Business Tax Reform, 1998 Corporate Management Tax Conference* (Toronto: Canadian Tax Foundation, 1998), 22:1-25, at 22:12.
- 119 The Mintz report, *supra* note 16, at 7.17.
- 120 *Ibid.*, at 7.15.